

# Directors' Duties in Management Buyouts and Leveraged Recapitalizations

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## I. INTRODUCTION

In recent years the level of merger and acquisition activity in the United States has been strikingly high, staggeringly so to some observers. In 1986, 4,024 transactions with a value of \$190,512.3 million were completed, topping the prior record set in 1985 of 3,397, valued at \$144,283.5 million.<sup>1</sup> Of equal interest is the nature of these transactions. Over one-fifth of those completed in 1986 were leveraged buyouts,<sup>2</sup> and by June 1987 completed buyouts for the year totaled \$34.3 billion.<sup>3</sup> Inevitably these transactions contributed to a general increase in leverage in the United States economy.<sup>4</sup> Thus, directors of public companies in the United States discharge their functions in an atmosphere of well-publicized and frequent mega-buck changes in corporate control, an atmosphere increasingly tolerant of highly leveraged corporate enterprise as well.

This Article examines the legal concerns of directors who authorize management buyouts (MBO's) and leveraged recapitalizations, two especially popular types of transactions affecting corporate control. This examination is preceded by a description of the basic effects of each of these transactions and a detailed analysis of the transactions' structure as defined by corporate law. In addition, the Article explores possible explanations and justifications for these transactions' popularity, and critically examines policy alternatives to deal with their problematic aspects. The Article develops two separate but interrelated arguments. First, the phenomenal popularity of these transactions is in significant respects driven by the demand for the financial assets they create. The impact of the October 19, 1987 market crash on such transactions is consistent with this explanation. Second, the demand-driven character of many of these transactions, coupled with the conflicts in interest inevitably

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1. See *1986 Profiles*, MERGERS & ACQUISITIONS 57 (May/June 1987). These statistics include only transactions valued at \$1 million or more involving a U.S. company, thus understating the full extent of merger and acquisition activity in the United States.

2. *Id.* In 1985, 13.5 % of the transactions were leveraged buyouts (LBO's).

3. See Cohen, *Leveraged Buy-Outs Facing Downturn*, WALL ST. J., Nov. 6, 1987, at 6, col. 1. In 1987, 259 LBO's with a total value of \$35.6 billion were completed, a decline from the \$46.4 billion record for 331 deals set in 1986. See *A Quick Rebound For M & A*, 22 MERGERS & ACQUISITIONS 7, 8 (May/June 1988).

4. Between 1963 and 1984, the ratio of debt to equity in United States corporations, as measured by the book value of assets, grew from 58.2% to 81.4%. See Coffee, *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 41-42 (1986). On the other hand, if the benchmark used in the comparison is the market value of corporate assets, corporate debt in the mid-1980s has been a slightly smaller proportion of capital than in the early 1970's. Furthermore, although by the first quarter of 1985 short-term debt was a record 52% of total debt for nonfinancial corporations, the contemporaneous fall in interest rates caused a drop in interest payments as a percentage of cash flow. See Labich, *Is Business Taking on Too Much Debt?*, FORTUNE, July 22, 1985, at 82.

presented by all of them, severely challenge directors' ability to assess proposed transactions in an appropriately informed fashion.

MBO's and leveraged recapitalizations have many similar effects. In both types of transactions, bank loans and long and medium term debt securities replace a substantial portion of the corporation's equity, while dividend distributions to shareholders cease and tax-deductible interest payments are made to creditors. Likewise, in both transactions a distribution of cash<sup>5</sup> or debt securities, or some combination of the two, is made to the corporation's public shareholders, in an amount in excess—often considerably in excess—of the current market price of their shares. Management's proportional equity stake in the entity increases substantially after the transaction. The final similarity is that after the completion of an MBO or a leveraged recapitalization, the firm is relatively invulnerable to hostile takeover attempts, at least for a period of time. As a consequence, both types of transactions have been used defensively as responses to unwelcome tender offers or merger proposals. The key dissimilarity is that while an MBO entirely eliminates public equity investment in the firm, a leveraged recapitalization, although it reduces both the ratio of debt to equity financing and the ratio of publicly-owned to management-owned equity, continues public equity investment.

Despite the elimination of public equity that follows an MBO, it is crucial not to confuse MBO's with transactions conventionally known as freezeouts. That terminology refers to merger transactions in which the person or entity acquiring the public shares—or causing the public equity to be bought out—already controls sufficient shares to constitute legal control of the corporation. In such transactions, the fact of majority share-ownership means that no competing bid for the minority interest will be made. Thus, when one sees a reference to "going private" transactions, one needs to inquire whether the acquiring party or entity, prior to the transaction, controlled a majority of the acquired corporation's shares.<sup>6</sup>

Both MBO's and leveraged recapitalizations result in much higher leverage and a much higher debt/equity ratio for the company undergoing the transaction. Whether a company's value is related to the composition of its capital structure is perennially disputed by financial theorists. The conventional view was that the composition of an enterprise's capital structure was determinative of firm value and that an enterprise's value would be enhanced by the use of long-term debt finance, up to a point of

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5. The amount of cash distributed to shareholders of United States corporations through non-dividend transactions has grown in magnitude in recent years. In the early 1970's, such payments amounted to about 15% of dividends. In 1984, they exceeded dividends and in 1985 totalled \$120 billion, almost 50% more than total dividends. See Shoven, *New Developments in Corporate Finance and Tax Avoidance: Some Evidence* (National Bureau of Economic Research Working Paper No. 2091, 1986).

6. It may be difficult to interpret the results of a study of transactions if it fails to draw this distinction. One recent study of premiums paid to shareholders appears to have treated all going-private transactions in the study as LBO's, and then reports only an "average" premium paid to shareholders in LBO's. The study's failure to distinguish between freezeouts and other going private transactions may thus result in a misleadingly low statement of the premium received for non-freezeout transactions. See K. Lehn & A. Poulsen, *Sources of Value in Leveraged Buyouts 2* (1987) (unpublished manuscript on file with author)[hereinafter Lehn & Poulsen]. In contrast, an earlier study included as a variable management's pre-transaction fraction of ownership of common stock. In this study of 72 going-private proposals from 1973-80, the median fraction for management's common stock ownership was 50.9%. See De Angelo, De Angelo & Rice, *Going Private: Minority Freezeouts and Stockholder Wealth*, 27 J. L. & ECON. 367, 382 (1984).

maximum advantage. Theorists with this view devoted much effort to studying the debt/equity ratios typifying various industries and types of firms, so that the optimal degree and type of leverage for particular firms could be defined.<sup>7</sup> The contrasting view posited that any firm's value was purely the function of its assets' ability to generate operating income, discounted to present value by a factor reflecting the risks of the business operated by the firm; capital structure, thus irrelevant to firm value, determined only the proper distribution of the firm's income stream to investors' various claims upon it.<sup>8</sup> Now for the first time, however, recent transactions in the United States suggest that reality has overtaken financial theory, and in particular that the determinants of corporations' use of debt in preference to equity finance are more complex than the financial theorists may have originally supposed.

## II. THE TRANSACTIONS DEFINED

### A. *Management Buyouts*

A management buyout (MBO) is a species within the corporate genus of leveraged buyout (LBO). The typical LBO involves four distinct transactions: (1) the formation of a new company to acquire all the assets or shares of an existing operating company or to acquire the assets of an operating division of a multi-division company; (2) the cash purchase of those assets or shares and a distribution to public shareholders of cash or a combination of cash and senior securities; (3) loans to the new company from banks and other institutional lenders to furnish the cash; (4) the distribution of the new company's equity to members of its management or to its various lenders.

Management and creditor holders of the new corporation's equity strongly hope that a fifth transaction will follow in a few years: sale to the public or at least to a broader group of private investors of equity interests in the new corporation. In most LBO's, the debt and equity participants expect that within five or six years the "excess" debt will have been retired, current interest costs will thereby have been reduced, and a public sale of equity will be feasible. To date, more than twenty companies involved in LBO transactions have subsequently come full cycle and made public offerings of stock.<sup>9</sup> In recent years, some round trips between LBO's and public sales of the new company's equity have taken less than two years.<sup>10</sup>

Conventional terminology restricts the "MBO" label to transactions in which some equity stake-holders in the new company were members of the senior management of the selling company. The basic transactional structure itself does not require such participation; the lenders and organizers of the new company may choose not to issue any equity to the new company's operating management, and, of course, they may choose new management without prior ties to the selling company.

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7. A well known example is B. GRAHAM, D. DODD & S. COTTLE, *SECURITY ANALYSIS* 546-47 (4th ed. 1962).

8. See generally V. BRUDNEY & M. CHIRELSTEIN, *CORPORATE FINANCE* 372-73 (3d ed. 1987).

9. See Anders, *Many Firms Go Public Within a Few Years of Leveraged Buyout*, WALL ST. J., Jan. 2, 1987, at 1, col. 6.

10. See Cohen, *Leveraged Buy-Outs Facing Downturn*, WALL ST. J., Nov. 6, 1987, at 6, col. 1.

Thus hostile LBO's are possible. MBO's are also occasionally used if a corporation sells an operating division to a group including its senior management.

Partial divestitures through MBO's are not further discussed in this Article because they are not legally problematic: the selling corporation is readily able to structure an arms-length transaction with the purchaser. Aspects of the basic MBO transaction, however, deserve further comment.

### 1. Sale of Assets or Shares to New Company

The implementation of an MBO requires a transaction or series of transactions through which the shares or assets of the company in question are sold to a newly-organized company, which will operate the business of the selling company after the MBO is completed. Three basic routes to achieve this end are possible. First, the newly-organized company (the "newco") may make an offer directly to the corporation's shareholders to buy their shares. The contractual relationships created through this tender offer will be between the newco and the selling shareholders; thus, they will not bind the corporation itself, unless additional contractual ties are created between the newco and the directors of the corporation that is the target of the MBO. Once the newco acquires a majority of the target's shares, it may be able to replace the corporation's directors.<sup>11</sup> The newco's offer need not be made for all shares; following a partial offer, or a not-entirely-successful offer for any and all shares, if the newco has acquired a majority of the shares, it can bring about a merger transaction with the subject corporation and through the merger, buy out the remaining minority shareholders. Merger transactions are more fully described below. The terms of the merger agreement need not give the minority shareholders consideration for their shares identical to that offered by the front-end tender offer.<sup>12</sup> If the target corporation has equity securities registered with the Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934, the tender offer will be subject to the Williams Act and the SEC's tender offer rules.

Second, corporation statutes in the United States enable corporations directly to bind themselves, through negotiated agreements, to sell their assets or shares through statutorily-defined sale of assets and merger transactions. If the transaction is structured as a sale of assets, and all or substantially all of its assets are to be sold, the selling corporation's directors would adopt a resolution containing the terms of the sale, and submit the resolution to the corporation's shareholders for their approval. Under section 271 of the Delaware corporation statute, shareholder

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11. Corporation statutes in the United States do not require that a majority shareholder have the right to remove directors without a showing of cause. Under the Delaware statute, if the directors serve staggered terms, unless the certificate of incorporation makes the directors removable without cause, directors can be removed only for cause. DEL. CODE ANN. tit. 8, § 141(k) (1974). Compare CAL. CORP. CODE § 303 (West 1977) (any or all directors may be removed without cause, unless the number of shares voted against removal of a director would be sufficient to elect a director, if voted cumulatively).

12. A front-end loaded MBO proposal using a tender offer structure was deployed in *Edelman v. Fruehauf Corp.*, 798 F.2d 882, 884-85 (6th Cir. 1986). The newco offered to purchase approximately 77% of Fruehauf's shares in a cash tender offer for \$48.50 per share; after the completion of the tender offer, Fruehauf would be merged with the newco and remaining Fruehauf shareholders would receive newco securities valued at \$48.50 for each of their shares.

approval requires a resolution adopted by "a majority of the outstanding stock of the corporation entitled to vote thereon," at a meeting called on at least twenty days notice.<sup>13</sup> If the corporation is subject to the Securities Exchange Act of 1934, any solicitation of proxies from its shareholders to vote their shares must conform to the proxy rules promulgated by the SEC. Under the Delaware statute, notwithstanding shareholder authorization of a sale, the directors may abandon the transaction without further shareholder action, subject to any rights "of third parties under any contract relating thereto."<sup>14</sup> Many practitioners believe that compliance with the meeting requirement imposed by state law, and with the SEC's proxy rules, requires more time than does compliance with the regulations imposed on issuer and third party tender offers.

Finally, the statutory authorization for merger transactions likewise mandates a two-step process of approval by directors and shareholders of a resolution proposing an agreement of merger that states the terms and conditions of the merger. Shareholder approval under the Delaware statute requires, as with a sale of assets transaction, that a majority of the outstanding stock of the corporation entitled to vote thereon vote for the adoption of the agreement of merger.<sup>15</sup> Ordinarily, merger agreements must be submitted for a shareholder vote at an annual or special meeting of the corporation, called on at least twenty days notice. A shareholder meeting need not be held, however, if the merger is between two corporations, one of which owns a very large proportion of the shares of the other. The Delaware statute sets a ninety percent threshold.<sup>16</sup>

Despite these similarities, one substantial difference between the statutory treatment of these transactions is significant to the structure of MBO's. Either a sale of assets or a merger can occur pursuant to the procedures authorized by corporation statutes despite the dissenting vote of some shareholders, so long as the statutory threshold for approval by a majority of the outstanding shares is met. The rights of the dissenting shareholder may differ, however, depending on the law of the company's state of incorporation. Under the Delaware statute and all others, shareholders who vote against a merger are entitled to appraisal rights. The appraisal rights defined by the Delaware statute permit dissenting shareholders to elect to pursue, as an alternative to the consideration offered to them by the merger agreement, an appraisal by the chancery court of the fair value of their shares and to receive payment of that value in cash from the corporate entity surviving the merger.<sup>17</sup> But the Delaware statute confines the appraisal right to mergers, and denies it to dissenters from corporate reorganizations structured through other modes, including sales of assets. Some other state corporation statutes, and the Revised

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13. DEL. CODE ANN., TIT. 8, § 271(A) (1969).

14. *Id.* § 271(b).

15. *Id.* § 251(c). In states that have adopted the Revised Model Business Corporation Act, a share exchange is an alternative transactional structure. Section 11.02 of the Act authorizes a corporation to acquire all of another corporation's outstanding shares pursuant to a plan of exchange adopted by the acquiring corporation's directors and, if required by the statute, approved by its shareholders.

16. *Id.* § 253(a).

17. *Id.* § 262.

Model Business Corporation Act, confer appraisal rights more broadly and do not restrict them to merger transactions.<sup>18</sup> Furthermore, Delaware courts have consistently rejected the judicial doctrine of the "de facto merger"<sup>19</sup> which some courts elsewhere have used to expand the availability of appraisal rights.<sup>20</sup>

The availability of appraisal is a significant consideration in structuring an MBO—or any other corporate reorganization of an ongoing business, for that matter—due to the cash drain that will result if many shareholders pursue their appraisal rights.<sup>21</sup> As a consequence, the proponents of the transaction have strong incentives to offer a sufficiently generous consideration in the merger agreement to reduce the prospective advantage to shareholders of pursuing appraisal. Offsetting these incentives are the financial costs, delay, and uncertainty borne by the shareholders who elect to pursue their appraisal rights.

Even given the financial burdens imposed by shareholders' appraisal rights, either route to a management buyout can be implemented on the basis of only one shareholder meeting, and without judicial approval of the terms of the transaction or their fairness. What must be done to satisfy the corporation's existing creditors involves addressing the question of their rights under individual loan agreements and indentures.<sup>22</sup>

## 2. Loan to the New Company

The bulk of MBO financing comes from banks, in the form of revolving credit or term loans that amortize over a ten to twelve year period. Additional subordinated or "mezzanine" debt may be sold to institutional investors and may take the form of preferred stock rather than debt securities. Lenders may bargain for and receive combinations or "strips" of senior and subordinated debt, preferred stock and common stock, warrants or rights to purchase common stock.<sup>23</sup> In their negotiations with the target corporation, the newco and its backers are likely to have access to significant items of non-public information about the target, of precisely the sort the target would resist making available to non-friendly bidders for control of the company.<sup>24</sup> The lenders' involvement is often aided by the selling corporation's

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18. REV. MODEL BUSINESS CORP. ACT § 13.02(A)(2)-(4) (1985).

19. See *Hariton v. Arco Elecs., Inc.*, 41 Del. Ch. 74, 188 A.2d 123 (1963) (sale of assets followed by planned dissolution and liquidation of corporation).

20. See *Farris v. Glen Alden Corp.*, 393 Pa. 427, 143 A.2d 25 (1958).

21. See generally Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223, 234 (1962).

22. If the newco defaults on its debt, preexisting creditors of the old company may be able to challenge aspects of the LBO-related transactions as fraudulent conveyances. See *infra* notes 88-91 and accompanying text.

23. See Canellos, *The Over-Leveraged Acquisition*, 39 TAX LAW. 91, 96 (1985). The use of warrants in these transactions is illustrated by the 1986 MBO for Beatrice Cos. Warrants to buy 24% of the newco's stock were issued to a partnership owned primarily by Drexel Burnham Lambert and its executives. Drexel helped to finance the MBO by selling \$2.5 billion in junk bonds issued by the newco. See Smith, *Planned Offer of Some Beatrice Assets Gives Look at Success of Most Leveraged Buyouts*, WALL ST. J., June 5, 1987, at 51, col. 3. Financial partners' demands for newco equity vary. The LBO firm arranging financing for its acquisition of Lucky Stores, Inc. chose a bridge loan from Merrill Lynch & Co. in preference to a junk bond package assembled by Drexel Burnham Lambert Inc. because Drexel wanted too much newco equity to suit the taste of the LBO firm. See Burrough, *Drexel, Despite Inquiries, Surges Back*, WALL ST. J., May 9, 1988, at 6, col.1.

24. See, e.g., *Edelman v. Fruehauf*, 798 F.2d 882, 890-91 (6th Cir. 1986).

agreement to lend financial assistance in various forms to the transaction. In a number of reported instances, the selling corporation's directors agreed to pay sizable commitment fees and cancellation fees to the financial firm that organized the transaction and that would, if the transaction occurred, become a newco creditor.<sup>25</sup> And in other reported instances, discussed more fully below, the newco has received options on favorable terms to purchase assets of the target corporation.<sup>26</sup>

### 3. Equity Allocation

Corporation statutes in the United States prohibit the issuance of shares for no consideration, and specify the types of consideration for which shares may legally be issued.<sup>27</sup> Thus, management's equity stake in the post-MBO newco cannot be issued entirely for free. One possible source for a cash contribution to the newco, in exchange for which shares could legally be issued, would be payments from golden parachutes, that is, additional compensation contingent on a change in corporate control. Management in any event may be able to finance a cash payment for its equity through a bank loan secured by a pledge of shares in the newco. Furthermore, introducing a high degree of leverage into a firm's capital structure will lower the book value of its shares; if management buys the stock at book value, the price will seem cheap in relation to its desired eventual market value.<sup>28</sup> Anyone challenging the transaction would nonetheless have difficulty establishing that the current market value of the stock exceeded its book value. It is not unusual for the allocation of equity in an MBO to be structured so that management participants receive the actual shares themselves—or so that restrictions on the shares' transferability expire—only after the expiration of employment contracts entered into by management with the newco at the time of the MBO. Further, management frequently receives performance-tied options to purchase shares.

All MBO's are structured on the assumption that, after repayment of the new company's debt, equity will be sold to additional holders. If one of the lenders has taken equity, it will likely be interested in a subsequent sale to free its capital for investment in other deals. Likewise, investment firms that assemble MBO deals (and typically take some portion of the highly subordinated "mezzanine" debt) are not in the business of serving as their clients' long-term creditors. Management holders of equity may favor the issuance of additional shares for sale to the public to reduce the riskiness of their own equity investments; senior management may even prefer to

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25. See, e.g., *id.* at 885 (selling corporation committed to pay \$30 million to Merrill Lynch for loan commitment fees, advisory fees and "breakup" or cancellation fee); *Hanson Trust PLC v. ML SCM Acquisition Inc.*, 781 F.2d 264, 269–70 (2d Cir. 1986) (selling corporation agrees to pay \$1.5 million engagement (or "hello") fee, \$9 million breakup (or "goodbye") fee, and \$6 million re-engagement (or "hello again") fee to Merrill Lynch); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 178 (Del. 1986) (selling corporation agrees to pay \$25 million cancellation fee to Forstmann Little & Co., to be placed in escrow and released to Forstmann if agreement terminated or another acquiror acquired more than 19.9% of Revlon's stock).

26. See text accompanying notes 140–141 *infra*.

27. See, e.g., DEL. CODE ANN., tit. 8, §§ 152–53 (1969).

28. Harley Davidson, Inc. is a dramatic example. Five years after an MBO, the newco sold shares to the public at \$11 apiece. Equity stakeholders in the MBO paid twenty-five cents per share. See Anders, *Many Firms Go Public Within a Few Years of Leveraged Buyout*, WALL ST. J., Jan. 2, 1987, at 1, col. 6.

dilute its own equity stake somewhat to mitigate the rigors of operating the company's business in a high-debt environment and to profit from selling the shares at a higher price than the management equity holders paid for them.<sup>29</sup>

Any transaction, like an MBO, that has the effect of taking a public company private is subject to the SEC's "going private" rule, which imposes additional disclosure obligations on the company involved in the transaction.<sup>30</sup> The rule is applicable if the transaction would cause any class of the issuer's equity securities that is subject to registration with the SEC under the Securities Exchange Act to be held of record by fewer than 300 people, or if any class of equity securities that is listed on a national securities exchange or quoted in an inter-dealer national quotation system would be neither listed nor quoted. An issuer proposing such a transaction is required by the rule to comply with fairly extensive disclosure obligations. These include specified items of financial information, including audited financial statements for the issuer's two most recent fiscal years. In addition, the issuer must disclose whether the issuer "reasonably believes" that the "transaction is fair or unfair to unaffiliated security holders."<sup>31</sup> The applicable instructions state that an issuer's response that it has no reasonable belief as to the fairness of the transaction "will not be considered sufficient disclosure."<sup>32</sup>

#### B. Leveraged Recapitalizations

The term "leveraged recapitalization" is used to describe the effect on a company's debt/equity ratio and share ownership of a number of different transactions. A leveraged recapitalization could, under Delaware law, be structured as a reclassification or a merger transaction, as a share repurchase, or even as a large special dividend. A reclassification would in formal terms require an amendment to the corporation's certificate of incorporation, reclassifying its existing shares into new shares and a class of preferred shares that immediately convert into cash, or a combination of cash and debt, under the reclassification plan.<sup>33</sup> Management's holdings of existing shares would, immediately prior to the reclassification, be exchanged for shares of another series of preferred, which would be convertible solely into new shares. After approval by the corporation's directors, the reclassification plan would be submitted to its shareholders at a special or annual meeting and would require approval of a majority of the outstanding shares entitled to vote thereon.<sup>34</sup> A reclassification is not a merger, and thus under the Delaware statute does not entitle dissenting shareholders to appraisal rights.

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29. Indeed, after some MBO's senior management holds less equity than prior to the transaction because high leverage in the acquisition enables them to cash out part of their prior investment while maintaining a comparable percentage of equity in the newco. See Note, *Fraudulent Conveyance Law and Leveraged Buyouts*, 87 COLUM. L. REV. 1491, 1502 & n.86 (1987).

30. *Going Private Transactions by Certain Issuers or Their Affiliates*, SEC Reg. § 240.13e-3, 3 Fed. Sec. L. Rep. (CCH) ¶23,703A (as amended effective Jan. 20, 1987).

31. Rule 13e-3 Transaction Statement, Item 8, 17 C.F.R. § 240.13e-100 (1987).

32. "Instruction," *id.*

33. See, e.g., DEL. CODE ANN., tit. 8, § 242(a)(3) (1973).

34. See *id.* § 242(b)(1).



If the recapitalization is structured as a merger, a newly-created corporation without assets (a "shell") is merged into the company. Thus after the merger the company is the surviving corporation. The merger agreement would provide that each share of the company be converted into a new share, plus cash or a combination of cash and debt securities, and would further provide that each share of the shell be converted into new shares. Immediately prior to the merger, the shell corporation's stock would be issued to management, in exchange for their shares of the corporation's stock. Dissenting shareholders would, under Delaware law, be entitled to appraisal.<sup>35</sup>

If the recapitalization is structured as a share repurchase, the corporation would offer to repurchase some substantial number of its shares in exchange for cash or a combination of cash, debt securities, and preferred stock. If debt securities are used, they may contain covenants limiting the issuer's ability to incur additional debt or sell or mortgage its assets. If these covenants are non-waivable, or the issuer's directors elect not to waive them, hostile leveraged bids for the company are unlikely to succeed.<sup>36</sup> A frequent aspect of recapitalizing through repurchase transactions is the simultaneous creation of an Employee Stock Ownership Plan (ESOP), to which the company issues shares. The ESOP might be enabled to purchase the shares by a loan from the company, which it will repay out of the company's tax-deductible contributions to the ESOP in the future. The long-standing policy justifications for the tax advantages conferred on ESOP's—all resonant with the virtues of workplace democracy and worker capitalism—may not fully have anticipated the use of ESOP's in plans that effectively insulate senior management from threats to its control of the company.<sup>37</sup>

Using an issuer exchange offer to recapitalize may turn out to be more expensive because of the need to offer shareholders a sufficiently large premium to induce them to tender, whereas management, which might seek to increase its proportionate equity by not tendering, then bears the financial burden eventually imposed by the incentive premium. Furthermore, corporations subject to the Williams Act regulations may no longer make issuer exchange offers on a selective or discriminatory basis.<sup>38</sup> Thus, because such bids must now be made on an all-holders basis, if a hostile or competing

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35. If many shareholders exercise their right to appraisal, favorable tax treatment of the transaction may be jeopardized. Full—or even partial—exploration of the tax dimensions of these transactions is beyond the scope of this Article. See generally Bryan, *Leveraged Buyouts and Tax Policy*, 65 N.C.L. REV. 1039 (1987). If a tax-related goal of the transaction is to structure it to assure that disbursements to shareholders are treated as gains incident to a reorganization—which as capital gains prior to the 1986 tax reform legislation were taxed at lower rate than ordinary income—an exercise of appraisal rights by a large number of shareholders may jeopardize that characterization and lead to characterization as a dividend. In the latter event, the entire amount received by a shareholder would be taxable; if the distribution is part of a reorganization, it is treated as a capital gain, so that the amount taxed is the distribution offset by the shareholder's basis in the stock.

36. See *Turner Broadcasting Sys. v. CBS, Inc.*, 627 F. Supp. 901, 906–07 (N.D. Ga. 1985).

37. See Note, *The False Promise of Worker Capitalism: Congress and the Leveraged Employee Stock Ownership Plan*, 95 YALE L.J. 148 (1985).

38. Rule 13e-4, which regulates issuer tender offers, was amended in 1986 to require that issuer exchange offers be made on an all-holders basis. See 17 C.F.R. § 240.13e-4(f)(8)(i) (1987). Prior to the change in the federal rules, the Delaware Supreme Court held that a discriminatory issuer self-tender was permissible under Delaware law. See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1983). Rule 14e-10(a)(2) requires all tender offers made by third parties to be made as all-holders offers.

bidder has acquired shares it cannot be excluded by the issuer as an offeree. Some leakage of the premium may therefore occur.

Finally, issuer exchange offers, like all share repurchases, do not require shareholder approval. This may occasionally create an advantage in timing if the transaction can be executed more expeditiously, but some observers believe that if the transaction is challenged in litigation, it may enhance the prospect of close judicial scrutiny as well.<sup>39</sup> Dividend transactions, like share repurchases and issuer tender offers, do not require shareholder approval, unless the dividend is incident to an amendment to the corporation's charter reducing its capital.<sup>40</sup> As discussed below, state corporation statutes subject dividends to various financial tests.<sup>41</sup>

Leveraged recapitalizations, like MBO's and LBO's, substitute large amounts of debt for equity in the corporation's capital structure. There are, nonetheless, two profound dissimilarities between leveraged recapitalizations and MBO's that raise provocative questions about both types of transactions. First, however the recapitalization is structured, the corporation's public shareholders receive shares—known as “stub” shares—in the post-recapitalization company, which they are free to hold, sell, or augment through additional share purchases.<sup>42</sup> The continued presence of public equity-holders, and the existence of a public trading market in the stub shares, means that leveraged recapitalizations are not “going private” transactions and thus are not regulated as such by the SEC. Any benefit achieved or any value created by a leveraged recapitalization does not hinge on the effects of eliminating public equity.

Second, in contrast to an MBO, a proposal for a leveraged recapitalization requires fewer decisions or valuation judgments that potentially advantage senior management at the expense of public shareholders. If an MBO is structured as a corporate merger or a sale of assets transaction, the selling corporation's directors must determine the price at which its assets will be transferred to the newco and the extent of the financial assistance the seller will lend to the transaction. On each of these questions, the interests of the selling corporation's public shareholders are in conflict with those of the prospective holders of equity in the newco. In particular, the lower the value placed on the selling corporation's assets, the lower the purchase price to be paid by the newco and the lower the amount of debt it will owe to its creditors.

In a leveraged recapitalization, if the transaction is structured as a merger or a reclassification, the directors must determine the ratio for converting management's old shares in the company into new shares. The risk to the public shareholders is that the directors will err on the side of generosity to management and overcompensate management equity participants by setting an exchange ratio that effectively

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39. See Lederman & Goroff, *Recapitalization Transactions*, 19 SEC. & COM. REG. 241, 248 (1986).

40. See DEL. CODE ANN., tit. 8, §§ 242(a)(3), 244 (1987).

41. See *infra* notes 86–87 and accompanying text.

42. Stub shares have proven to be highly volatile. During the 1987 market downturn, market prices of many stubs fell faster than the market averages. An index of shares of companies associated with Drexel Burnham Lambert, the most active underwriter for high-debt companies, fell 50% between August 28 and October 28, 1987, when the Standard & Poor's 500 stock index dropped by 30% over the same period. See Smith, *Performance of High-Debt Firms After Crash Bears Out Warnings of Volatility in Downturn*, WALL ST. J., Nov. 3, 1987, at 71, col. 3.

undervalues the new shares relative to the old shares. This undervaluation, however, may be reflected in the market price of the issuer's "old" stock when the recapitalization proposal is announced—if the "new" shares have been undervalued in this way, and if sufficient information is publicly available to assess the valuation decision, the market price of the "old" shares would be higher than anticipated—and in response the exchange ratio could be readjusted or the amount of the cash component raised.<sup>43</sup> If such an adjustment is not made, the transaction—and control of the company—would be vulnerable to a hostile bid.

### III. CAUSES, EFFECTS, AND EXPLANATIONS

#### A. Various Causes

Many aspects of recent MBO and leveraged recapitalization transactions are striking. A substantial number of companies have been involved in such transactions, and many of these firms are large and well established household names that, as a result of the transaction, operate with a level of debt well beyond the limits of prudence prescribed by conventional financial theory. A leading example is the 1986 MBO for R.H. Macy & Company, a large chain of retail department stores including, in New York City, the nation's single largest department store. The MBO had the effect of increasing the firm's total debt to \$3.7 billion, a ten-fold increase from its pre-MBO level of \$324 million in long- and short-term debt.<sup>44</sup> Public shareholders in Macy's received sixty-eight dollars per share, which represented a premium of twenty-six dollars over the forty-two dollar range in which the stock traded in the week preceding announcement of the buyout proposal. After the transaction, the newco (Macy Acquiring Corp.) had a prodigious ratio—in excess of ten to one—of long-term debt to shareholders' equity.<sup>45</sup> The Macy's transaction, although more highly leveraged than many, was not anomalous.

A number of factors unquestionably have contributed to the popularity of such transactions in recent years. LBO's, prior to the early 1970s, were used in acquisitions of private companies. In the 1970s, the LBO technique was applied to publicly-held companies that had family or founder ownership of controlling stock. This era in the United States featured relatively high interest (and inflation) rates and

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43. See Lederman & Goroff, *supra* note 39, at 246 (1986).

44. See N.Y. TIMES, Feb. 20, 1986, at D5, col. 5. Macy's shareholders were originally offered \$70 per share (later reduced to \$68 per share) which represented a payout of about nine times the company's free cash flow. Prior to this transaction, most analysts had assumed that five or six times cash flow was a likely figure for leveraged transactions.

45. For its fiscal year ending Aug. 2, 1986, Macy Acquiring Corp. had \$2,872,251,000 in long term debt, \$273,489,000 in preferred stock, and total shareholders' equity of \$277,724,000. How is this capital structure feasible? For one thing, total current assets (\$1,437,695,000) were only slightly in excess of total current liabilities (\$1,140,273,000). See "Macy Acquiring Corp.," Dow-Jones Retrieval Network (Search July 1, 1987).

This contrast is especially striking if one keeps in mind that the current assets of a department store would include a relatively high proportion of inventory. This enterprise thus appears to have little operating flexibility, and to be running a business vulnerable to rapid shifts in consumer tastes. The prospectus filed with the SEC for an offering of debentures at the time the MBO was initially announced described plans to sell or refinance some of Macy's interests in nine shopping centers it owned wholly or partially. N.Y. TIMES, Feb. 20, 1986, at D5, col. 5. These sale transactions might not necessarily reduce the firm's current needs for cash, depending on the schedule for payment of the purchase prices, if Macy's continues to operate at these locations and if the properties are leased back in exchange for cash lease payments.

relatively low stock market prices. Companies thus became candidates for LBO's when their stock traded at prices well below the book value of their assets, so that while the assets' value could not be effectively realized through public offerings of shares, asset value was nonetheless sufficient to secure debt financing. A "sale" of such a company's assets through an LBO would also in many instances be a sale at a price below the assets' tax basis, and would thus be productive of favorable tax consequences for the company and its controlling shareholders.

By the late 1970s, LBO activity shifted to a somewhat different population of companies, typically those with high cash flow coupled with limited prospects for additional business growth. These companies are LBO candidates because, to enable the LBO transaction, lenders are willing to lend, on an unsecured basis, an amount justified by the company's cash flow, even if in excess of its market capitalization. A significant basis for lender involvement, implicit in this current generation of LBO's, is a shift from secured asset financing to unsecured debt.<sup>46</sup> In some transactions, the newco's ability to meet its debt service obligations depended on its ability to sell off assets after the LBO.<sup>47</sup> The same period was also characterized in

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46. A record of sorts may have been established by the 1987 LBO for Burlington Industries, Inc. led by Morgan Stanley & Co. The price announced in June represented a price-earnings multiple of around 36. See Stewart & Hertzberg, *Speculative Fever Ran High in the 10 Months Prior to Black Monday*, WALL ST. J., Dec. 11, 1987, at 20, col. 1.

47. The LBO for Burlington Industries is an exemplar. In a filing with the SEC in August 1987, Burlington disclosed that it did not expect to generate sufficient cash from operations to make estimated payments to bank lenders of \$650 million in June 1988 and \$250 million in June 1989. The market crash in October 1987 reduced the prices at which Burlington was able to sell assets. On November 5, it sold one large denim plant to Dominion Textiles for \$205 million, a price reported to be less than Dominion had theretofore been willing to pay. See Cohen, *Companies Provide Illustrations of Problems in Buy-Out Business*, WALL ST. J., Nov. 6, at 6, col. 2. In the fourth quarter of 1987, Burlington incurred a \$25.3 million loss despite increased earnings from operations; during that quarter, Burlington had \$66.1 million in interest expense. See Clark & Malabre, *Takeover Trend Helps Push Corporate Debt And Defaults Upward*, WALL ST. J., Mar. 15, 1988, at 1, 28, col.2.

As it happens, the immediate impetus for the Burlington LBO was a hostile bid from Dominion in association with Asher Edelman. Some aspects of the response to the Dominion-Edelman bid are troubling. The North Carolina General Assembly enacted in a matter of days the Control Share Acquisition Act, revising the original draft legislation to ensure that Burlington was covered. See North Carolina Control Share Acquisition Act, ch. 182, § 1, codified at N.C. GEN. STAT. §§ 55-90 to -98 (Supp. 1987). As originally drafted, the statute applied only to corporations with more than 50% of their domestic assets and employees within the state. See Hazen, *Corporate Director Accountability: The Race to the Bottom—The Second Lap*, 66 N.C.L. REV. 171, 180 (1987) (questioning statute's constitutionality because of the way it was "tailored to a specific fact situation").

As enacted, the statute applies to domestic corporations with substantial assets in the state. It applies to any foreign corporation with more than five hundred shareholders that, at the end of each of its two most recent fiscal years and most recent fiscal quarter, had more than 40% of its domestic fixed assets in North Carolina and more than 40% of its domestic employees resident in North Carolina, its principal office or place of business in North Carolina, and either more than 10% of its shareholders resident in North Carolina or more than 10% of its shares owned by North Carolina residents. Under the Act, if a person acquires more than specified percentages of a corporation's voting power, the shares acquired will not have voting rights unless those rights are granted by a resolution adopted by a majority of the corporation's outstanding shares, excluding those beneficially owned by the prospective acquiror of control shares, the issuer's officers, and directors. Under section 55-95, unless the corporation has a bylaw or charter provision providing otherwise, if the control shares are accorded voting rights, and have a majority of voting power for the election of directors, all other shareholders have a right to have their shares redeemed by the corporation at their fair value as of the day prior to the shareholder vote on the control shares' voting rights.

Assessing the statute's vulnerability to challenge on constitutional grounds is a complex task. One level of inquiry is suggested by the prohibition in article II, section 24(1)(j) of the North Carolina constitution on any "local, private, or special act or resolution . . . [r]egulating labor, trade, mining or manufacturing. . . ." This provision and its predecessors were responses to the offensiveness of special legislation to the norm that "[t]he General Assembly is for general legislation. . . ." See Ferrell, *Local Legislation in the North Carolina General Assembly*, 45 N.C.L. REV. 340, 350 (1967) (quoting 1911 legislative reform proposal of Governor Kitchin). A "special" law, under interpretations of this provision, is one "imposing particular burdens or conferring special rights, privileges or immunities upon a portion of the people

the United States by relatively low interest rates, higher stock market prices, and many high-profile hostile bids for corporate control. After the market collapse in October, 1987, the financial environment affecting LBO's and leveraged recapitalizations changed noticeably. Stock market prices remained depressed and many investors came to perceive the risk of a recession in the near future. Investment bankers predicted a return to "saner times," and in particular a return to less-highly-leveraged transactions priced so the newco could repay its debt from its cash flow.<sup>48</sup>

Thus the story is not a simple one, and the attractiveness of MBO's and leveraged recapitalization transactions depends on many factors. Many of these factors determine the demand for the assets produced as a result of these transactions—that is, they affect investors' interest in purchasing or holding the debt or equity securities created by the MBO or the leveraged recapitalization. It is difficult to resist the conclusion that, at least in part, the recent popularity of MBO's and leveraged recapitalizations has been demand-driven.

The recent use of leveraged recapitalizations, for example, clearly reflects the relatively high prices for equity securities sustained by U.S. stock exchanges over the same period. Stubs will not yield dividends for a considerable period of time, due to their issuers' debt service obligations, and a takeover bid for the company at a premium price is not likely. The attractiveness of stubs to public investors thus depends on equity investors' willingness to assess the issuer's future prospects generously on the basis of its present cash flow. To the extent that the corporations undergoing such metamorphoses tend also to have relatively low prospects for future business growth, little else is left in the picture to explain public investors' interest in owning their equity, a willingness that is far from invulnerable to subsequent downward "corrections" in the stock market prices generally. In this period, high stock market prices may have made stubs seem cheap relative to other equities' prices, but this appearance may well be transient.<sup>49</sup> On the other hand, if public investors reinvest at least part of the cash payouts generated by MBO's and leveraged recapitalizations, unless many new public offerings of shares occur at the same time, stock market prices should be sustained by the reinvestment.<sup>50</sup>

Likewise, the cost of the debt component in these transactions is not immune to general market shifts. If the firm's prospects for future business growth are less than stunning, its capacity to pay interest on debt financing is controlled by its present

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of the State without including therein and being applicable to all of the class throughout the State." *State v. Dixon*, 215 N.C. 161, 171, 1 S.E.2d 521, 526 (1937) (Barnhill, J., concurring). Under this approach, if the legislation first defines a class and then states exclusions from that class, the judicial inquiry then examines whether "a sound reason" justifies the exclusion or whether the legislative classification is "arbitrary and discriminatory," denying or granting privileges on that basis contrary to the Act's declared purpose. *See id.* at 172, 1 S.E.2d at 527.

On the federal constitutional front, merely the fact that the statute is "special" is not in itself a criterion for invalidation. *See generally* Sunstein, *Naked Preferences and the Constitution*, 84 COLUM. L. REV. 1689 (1984). The most fruitful avenue of challenge under the federal constitution would probably use the judicial application of the commerce clause to prohibit certain types of state regulation of interstate commerce. The Court most recently considered the permissible scope of state takeover regulation in light of the commerce clause in *CTS Corp. v. Dynamics Corp. of Am.*, 107 S. Ct. 1637 (1987).

48. *See supra* note 10, at 6, col. 1.

49. *See supra* note 42.

50. *See* Maiden, *Abundance of Cash Powers U.S. Market*, AUST. FIN. REV., July 31, 1987, at 28, col. 1.

operating results, so that increases in the market rate of interest reduce the amount of debt that the enterprise can service. Indeed, the use of variable or floating rate debt in many such transactions means that post-transaction increases in market rates of interest can substantially increase an enterprise's costs of debt service.

Whether the debt resulting from MBO's and leveraged recapitalizations is attractive to banks and prospective investors is a similarly complex question. At the outset, it is helpful to distinguish between senior creditors—usually banks and other financial institutions—and junior or subordinated creditors who purchase the unsecured debenture debt. A bank's decision to participate as a senior lender in any given transaction represents an investment choice among types of loans the bank might make. The troubles of large United States banks in recent years illustrate that mistaken investment choices produce bank assets of dubious quality. At least in this recent era, the supply of potential high-quality bank assets was not unlimited. In short, the popularity of senior corporate debt to banks may in part reflect banks' disillusionment with other types of borrowers—oil drilling ventures, governments of developing countries, domestic farm operations, real estate developers—who earlier enjoyed the banks' exuberant embrace.

Recent history suggests some good explanations for the relative attractiveness of LBO debt to banks. First, the range of factors that may cause the borrower to default are fewer in number and more likely to be within the borrower's control than is the case for many other types of loans. Loans to foreign sovereigns provide an especially dramatic contrast. Domestic corporate borrowers are only indirectly affected by political factors, like changes in the composition of a government, that may directly lead to a foreign sovereign's decision to default. Likewise, the experience of the last few years suggests that foreign sovereign debt is much more vulnerable to exogenous economic risks—chief among them world-wide price levels for oil and other commodity products—than is domestic corporate debt. Finally, the creditor has a more extensive range of legal remedies available against private domestic borrowers who default than it does against foreign sovereigns.

An additional factor is the quality and extent of the information on which the bank can assess the risks presented by the loan. The quality of information available to the lender in connection with an LBO is superior to that on which many other types of lending decisions have been made. If the company involved has equity securities registered with the SEC, an LBO transaction would be regulated by the SEC's "going private" rule. Compliance with that rule normally entails submitting both audited financial statements for the issuer's two most recent fiscal years and unaudited financial statements for the issuer's most recent quarter.<sup>51</sup> Under the statutory scheme, misstatements or omissions in such materials are culpable.<sup>52</sup> In contrast, a

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51. See 17 C.F.R. § 240.13e-3 (1987).

52. Section 10(b) of the Securities Exchange Act of 1934 makes it illegal to use any "manipulative or deceptive device or contrivance" in connection with the purchase or sale of securities in contravention of the SEC's rules. Rule 10b-5 prohibits the use of any untrue statement of a material fact, or the omission of a statement of a material fact necessary in order to make the statements made not misleading, in connection with the purchase or sale of any security. The statute authorizes the SEC to bring actions for injunctive relief in the federal district courts and permits the rescission of contracts made in violation of the statute or rules promulgated under it; an extensive body of federal case law addresses

number of large United States banks made sizable loans to exploratory oil drilling ventures on the basis of "information" produced through a combination of wishful thinking and creative writing.<sup>53</sup> Thus, although other factors may contribute to the popularity of LBO debt, for bankers who recall all too well their difficulties in accurately assessing the risks presented by other types of borrowers, a persistent optimism about the quality of LBO debt would be easy to justify.

The popularity of the subordinated debt securities created by LBO's and leveraged recapitalizations among financial institutions and other investors reflects, among other things, the attractive return offered, in contrast to the yield on competing investment opportunities, in relationship to the perceived low risk of default. To date, only one large corporation is widely known to have defaulted on LBO debt.<sup>54</sup> Many private institutions, such as universities and pension funds, are concerned with investing endowment funds so as to minimize the risk of loss of principal, while achieving a high enough current return to generate current income to support operating activities.<sup>55</sup> LBO debt has been especially attractive lately because, given its perceived level of risk, the rate of return is superior to many other income-generating securities, in light of the relatively low market rate of interest in recent years.

For many of the same reasons, various sorts of institutions and pension funds have invested in LBO equity through a pooled investment vehicle created by the leading firm in arranging LBO's.<sup>56</sup> Relatedly, in the same period many corporations used speculative-grade debt securities ("junk bonds") to finance expansion and, to

the circumstances under which private parties may sue for injunctive relief or money damages under any section of the statute, including section 13(e).

53. See M. SINGER, *FUNNY MONEY* (1985) for a description of the lending practices that led to the failure of the Penn Square Bank of Oklahoma City and the reorganization under the auspices of the federal bank insurance authority of the Continental Illinois Bank of Chicago.

54. Kaiser Steel defaulted on loans and skipped preferred stock dividends after two successive buyout transactions in two years left the company with \$230 million in annual revenues, \$25 million in preferred dividend payments annually and a \$27 million annual obligation for pension and health benefits to steelworker families. See Sloan & Fuhrman, *An American Tragedy*, *FORBES*, Oct. 20, 1986, at 30, 33.

Other LBO borrowers may have occasional but less devastating difficulties and as a result seek to restructure their debt. See Blumenthal, *Republic Health, Ailing After Buyout, Brings in New Chief, Plans Restructuring*, *WALL ST. J.*, July 30, 1987, at 12, col. 1. Some observers believe the widely-heralded financial success of LBO's in large companies led to their use in smaller concerns that did not fit the conventional criteria of appropriateness for an LBO, such as predictable earnings and readily sellable assets. See Cowan, *When a Leveraged Buyout Fails*, *N.Y. TIMES*, Oct. 18, 1987, Sect. 3, at 1, col. 2 (collapse of Mushroom King, Inc.).

55. One university reports that it is now pursuing a strategy of investing up to one fourth of its endowment funds in what it terms "nontraditional investments," including foreign securities, venture capital, real estate, and leveraged buyouts. See Bloch, *Learn Now, Pay Later*, 73 *DUKE: A MAGAZINE FOR ALUMNI AND FRIENDS* 12, 15 (1987).

Along the same lines, one large pension fund recently reported a net gain of \$61.2 million from its sale of equity in Calgon Carbon Corp. In exchange for making a 10-year, \$9.5 million loan to the buyers at 15.5% interest, the fund received shares of stock and warrants in the newco. The fund subsequently sold its shares and some of the warrants back to the newco, then exercised the remainder of its warrants for common stock, which it sold to the public in conjunction with the company's public offering. TIAA-CREF The Participant, Aug. 1987, at 6.

56. See Sterngold, *Kohlberg Is Raising \$5 Billion*, *N.Y. TIMES*, July 10, 1987, at 25, col. 1. In 1986, the same firm, Kohlberg, Kravis Roberts & Co., raised \$2 billion for a fund to make equity investments in LBO's it arranged. KKR's offering circular for its 1987 \$5 billion fund states the firm has produced a compounded annual return of 60% since its founding in 1976. KKR charges a 1.5% annual management fee for its funds and thus, independent of its ability to invest all of the fund in LBO equity, will receive \$75 million annually once the full \$5 billion is raised. The fund, pitched to institutions, has a minimum investment of \$25 million, and was expected to meet its \$5 billion goal within several months.

a much lesser extent, to finance hostile takeovers.<sup>57</sup> In general, the depth of the U.S. market for high-yield corporate debt—for junk bonds as well as subordinated LBO debt—is unquestionably a key institutional determinant of the popularity of the types of transactions under discussion.

To be sure, investor appetite for subordinated corporate debt and LBO equity, although voracious at times, is not insatiable. The pool of companies that are attractive candidates for MBO's and leveraged recapitalizations is inevitably limited. This fact means that, at some point, the "candidates" will feature higher levels of business risk or lower stability of cash flow, and prospective creditors either will become increasingly reluctant to finance the transactions or will demand even higher returns for the use of their funds. Likewise, if the next cyclical drop in the general business cycle results in defaults on outstanding LBO debt, the attractiveness of new LBO's to prospective creditors will be jeopardized. Events after the October 19 collapse demonstrated the fragility of this market. Outstanding issues of junk debt traded at a substantial discount,<sup>58</sup> and underwriters' ability to place new issues of junk debt was severely limited.<sup>59</sup> The sudden unpopularity of junk debt is exemplified by the fact that the average interest rate required for Southland Corp. to sell its high-yield bonds needed to complete its LBO increased by two percentage points after the October crash.<sup>60</sup>

MBO's and leveraged recapitalizations are sometimes used defensively, that is to preclude or defeat a hostile bid for the company. This usage is ultimately vulnerable to declines in hostile acquisition activity, which in turn is vulnerable to changes in takeover regulation and in relative currency values (which cheapen or make more expensive the acquisition of U.S.-dollar-denominated investments by foreign investors). Although a decline in merger and acquisition activity in the United States was widely forecast for 1987, due to extensive revisions to the federal tax laws in 1986, in the first five months of 1987, 2,056 mergers and acquisitions were announced, totalling \$106.3 billion, compared with 1,800 deals totalling \$78.2 billion for the same period in 1986. A substantial portion of this activity is attributable to defensive transactions, including MBO's and leveraged recapitalizations.<sup>61</sup> Hostile takeover activity was also vulnerable to the financial consequences of the market crash. Some repeat offerors, in particular, experienced sharp declines in the value of

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57. Ninety-two billion dollars of high-yield corporate debt was issued between 1977 and 1986 by U.S. companies. But between 1980 and 1986 only two percent of the publicly-issued junk debt was used to finance hostile takeovers, and in 1986 only six percent of the junk debt sponsored by Drexel Burnham Lambert—much of which was privately placed by that firm—financed hostile bids. See *THE ECONOMIST*, July 11, 1987, at 13 (survey). See generally Securities & Exchange Commission, Office of the Chief Economist, *Noninvestment Grade Debt as a Source of Tender Offer Financing*, [1986–1987 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 84,011 (1986) (study of tender offer financing 1981–1985). Of course "junk debt" to its critics is "high-yield" debt to persons selling it.

58. After the crash, junk bond yields increased by nearly 300 basis points. See *The Hunt for M & A Bargains*, *MERGERS & ACQUISITIONS* 9, 10 (Jan./Feb. 1988). One "basis point" equals 0.01 % of the bond's value. Spreads of actively-traded junk bonds to Treasury bonds widened by 325 basis points, and the spread on lower-rated bonds grew by 433 basis points. See Picker, *Ebb Tide on Wall Street*, *INSTITUTIONAL INVESTOR*, Dec. 1987, at 69, 73.

59. *Id.* at 10 (reporting investment banker's observation that, "[e]ven if you wanted to pay 300 basis points more, you couldn't place it.").

60. See Lancaster, *Southland's New Junk-Bond Offering is Less Risky, But Only in Short Term*, *WALL ST. J.*, Dec. 4, 1987, at 20, col. 2.

61. See Burrough, *The Takeover Business Is Alive and Well*, *WALL ST. J.*, June 26, 1987, at 6, col. 1.



their existing investments, while the financial capacity of any offeror dependent on the junk bond market appeared problematic. In this post-crash environment, the financial health of risk arbitrageurs ailed even more drastically than that of other market participants.<sup>62</sup> Indeed, after the crash, no major tender offer was made until, on January 6, 1988, F. Hoffman-La Roche & Co. bid \$4.2 billion for Sterling Drug, Inc.<sup>63</sup>

Complex corporate transactions like these require complex—and expensive—services from financial advisors and lawyers, and thus the continued vitality of the acquisition business enhances financial prosperity for selected service firms as well. The record to date for advisory fees is the \$45 million received by Kohlberg, Kravis Roberts & Co. for arranging in 1986 the \$6.2 billion MBO for Beatrice Companies.<sup>64</sup> Not surprisingly, investment advisory firms that assemble these transactions aggressively promote their services to prospective clients.<sup>65</sup> Some investment bankers have recently been willing to invest their own money in their clients' deals, buying LBO equity and making "bridge" loans to acquirors until more permanent financing can be arranged. Investment bankers' willingness to bear direct financial risk in clients' transactions is attributed by some observers to the firms' desire to retain their traditional client base.<sup>66</sup> The motivating consideration thus would be the investment bank's determination to preserve or enhance fee income generated by advising its corporate finance clients, at the cost of an enhanced investment risk to its own capital. This explanation, however, overlooks the spectacular fees charged for bridge loans in comparison to fees for more mundane merger and acquisition advisory services.<sup>67</sup> The market collapse, by crippling underwriters' ability to place new junk debt, threatened to convert some bridge loans into commitments of capital of much longer duration than the parties anticipated.<sup>68</sup>

62. The crash eliminated half the estimated \$12–15 billion capital of risk arbitrage firms. See Burrough, *Arbitrageurs Cheer Sterling Drug Bid after Week of Slow Takeover Activity*, WALL ST. J. Jan 6, 1988, at 4, col. 1.

63. See *id.* Arbitrageurs' reaction to the bid was unquestionably cheered by its financing, which did not involve resort to the junk bond market. In its SEC filing, Hoffman-La Roche disclosed that Swiss Bank Corp. would provide at least \$1 billion and could raise an additional \$3.2 billion from other banks, all subject to the negotiation of definitive loan agreements. See Lee, *Sterling Drug to Fight \$4.2 Billion Bid, Any Other, Hoffman-La Roche Says*, WALL ST. J., JAN. 6, 1988, at 4, col. 3.

64. See Williams, *King of the Buyouts, Kohlberg Kravis Helps Alter Corporate U.S.*, WALL ST. J., April 11, 1986, at 1, col. 6.

65. See Stewart & Hertzberg, *Investment Bankers Feed a Merger Boom and Pick up Fat Fees*, WALL ST. J., April 2, 1986, at 1, col. 6. An aspect of the service may be "pre-selling" the target's assets, that is finding potential buyers for various assets before the newco or a hostile bidder owns them. *Id.*

66. See, e.g., *Roundtable: How Wall Street is Expanding in Merchant Banking*, MERGERS & ACQUISITIONS 26, 39 (Jan./Feb. 1988) (reporting investment banker's characterization of bridge finance as "a service that we make available to a client in a particular transaction").

67. First Boston Co. earned a \$90 million fee by committing its capital to Campeau Corp. in Campeau's takeover of Allied Stores. First Boston made a \$865 million bridge loan, which was paid back through the proceeds of a junk bond issue. This process took four and a half months. See THE ECONOMIST, July 11, 1987, at 10 (survey).

68. See Swartz, *Goldman Sachs and Salomon are Hit by Southland Corp.'s Financing Woes*, WALL ST. J., Nov. 11, 1987, at 2, col. 2. Goldman and Salomon lent \$100 million each in short-term bridge loans to Southland Corp. to finance its LBO on the assumption that these loans could quickly be repaid by selling Southland debt securities to investors. The loans paid interest at five percentage points above the prime rate. *Id.* The Southland offering was the first post-crash refinancing of a major bridge loan with public debt. It was delayed by three weeks by the post-crash turmoil in the junk bond markets, and its eventual completion required that the most junior of four levels of subordinated debt be sweetened with warrants convertible into Southland stock. See Burrough & Totty, *Southland's \$1.5 Billion Bonds Priced, Giving Boost to the Takeover Market*, WALL ST. J., Dec. 8, 1987, at 14, col. 3. Indeed, the delay in completing the deal

The shift for investment bankers from a purely advisory function to a capital-commitment function parallels the shift in the United States securities-brokerage business from a fixed commission-compensated agency business to a trading and market-making business, in which the firm risks its own capital as a principal. Enormous—and in some instances fatal—losses have resulted for some firms as a result of their trading activities.<sup>69</sup> For some firms, a commitment of firm capital to LBO's, by diversifying the firms' investments, also diversifies against the risk of trading losses.<sup>70</sup> An investment bank's decision to commit its own capital to a client transaction may also call into question its ability to advise clients in an appropriately dispassionate fashion. Relatively few large investment banks have been dissuaded by this possible divergence in perspective from undertaking functions requiring commitments of the firm's capital.

In short, these have been profitable transactions for many parties—for the specialized firms that promote and assemble them, for bank lenders, and for the wider cast of investors who buy the equity and subordinated debt securities. Unquestionably—but probably unquantifiably as well—demand for the fruits of these transactions has enhanced the supply of corporate candidates.<sup>71</sup> The sensitivity of these transactions to the post-crash changes in demand for resultant financial assets illustrates their demand-driven qualities.

## B. Explanations

### 1. Not-So-Sympathetic

Academic commentary, which heretofore has concentrated on MBO's, differs on whether these transactions and their consequences should be viewed from an optimistic or a pessimistic perspective. One point of departure is the source of the generous premium over market price paid to the company's public shareholders or, put a bit differently, the rationale for the higher value assigned to the corporation's assets by the equity and debt participants in the MBO than the lower value implicitly

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caused it to be known within Salomon as the "Texas chain-store massacre." See INSTITUTIONAL INVESTOR, Dec. 1987, at 28.

Completion finally required the company and its underwriters to abandon their plans to structure some of the debt securities on a "paid in kind" or PIK basis. See INSTITUTIONAL INVESTOR, Jan. 1988, at 114. PIK securities pay interest or dividends in additional junk securities. Thus, they underperform more senior securities because their holders do not receive any real money (i.e., cash) until the securities mature, typically in two to five years. The PIK's proposed for Southland would have been expressly noncallable by the issuer, which was believed to require too expansive a leap of faith by prospective investors. Additionally, under the original proposal, the family purchasing Southland reportedly refused to allocate any newco equity to the underwriters, Goldman and Salomon, so they were unable to offer equity as well as debt to investors. See *id.* Thus the eventual inclusion in the package of equity warrants accompanying the most junior debt, and the elimination of the PIK feature, are indicative of a market-responsive restructuring of the transaction.

69. See K. AULETTA, GREED AND GLORY ON WALL STREET: THE FALL OF THE HOUSE OF LEHMAN (1986).

70. Merrill Lynch & Co. reported earnings for the second quarter of 1987 of \$83.3 million despite incurring a \$377 million loss in its mortgage trading operation, due in part to estimated pre-tax earnings of \$59 million on revenues attributable to two large LBO's. Merrill arranged LBO's for Borg-Warner Corp. and Supermarkets General Corp. See Swartz, *Merrill Lynch Posts 2nd-Quarter Profit of \$83.3 Million Despite Trading Losses*, WALL ST. J., July 21, 1987, at 3, col. 2.

71. See Lowenstein, *Management Buyouts*, 85 COLUM. L. REV. 730, 736 (1985) (describing institutionalization of MBO market).

ascribed to the same assets by the public trading market for the corporation's shares. The enhanced value achieved by some transactions can be attributed only to the tax benefits they achieve. The particular nature of these benefits, of course, depends on the individual transaction. Generally, however, debt is a cheaper source of capital than equity due to the deductibility to the corporation of interest payments and the nondeductibility of dividends. Some tax benefits based on discrepancies in valuation can be utilized only if a transaction—such as a sale—realizes a loss or gain. Indeed, scholars have identified particular buyout transactions in which little if any operational change in the company's business followed the buyout, so that the sole plausible explanation for the generous premium paid to public shareholders is the realization of tax savings of various sorts.<sup>72</sup>

Along the same lines, a recent study of a sample of leveraged buyouts during 1980–84 found a significant relationship between the premiums paid in the LBO's and the companies' pre-LBO effective tax liability.<sup>73</sup> The same study, however, found no empirical support for the view that LBO's confer value on shareholders at the expense of the corporation's present bondholders. For the sample studied, bond prices did not suffer any net-of-market decline in trading price around the time of the issuers' announcement of the LBO proposal. This statistical data may be of some general comfort, but may fail to impress lawyers acquainted with the facts of a recent case, *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*<sup>74</sup> After Revlon announced its MBO proposal in response to a hostile bid, the market price of notes that Revlon had issued earlier in connection with an issuer exchange offer dropped from \$100 to \$87.50. In general, proposed transactions that will dramatically increase a firm's leverage and create additional claims on its assets are not good news for present holders of the firm's existing long-term debt. The precise degree of adversity perceived by present creditors may vary nonetheless.

Drastic increases in an enterprise's debt may also provide an occasion for the sale of selected assets, unquestionably in large part to generate cash to enable the company to repay the principal amount of part of the debt. Indeed, in the largest MBO announced to date, under the terms of the original proposal the newco's projected debt service requirements—the interest payments—would have exceeded its projected cash flow and thus inevitably would require cash proceeds from asset sales.<sup>75</sup> It is difficult to assess the contribution of asset sales, as such, to MBO premiums without a more systematic study of asset sales than appears to have been done to date. Are MBO's leading to the sale of the firm's most productive and most

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72. See *id.* at 759.

73. See Lehn & Poulsen, *supra* note 6, at 20–21.

74. 506 A.2d 173, 178 (Del. 1986). Relatedly, it is not unusual for a rating agency to downgrade the debt securities of a company executing a major cash acquisition or undergoing an LBO. See *Aftershock of Acquisitions*, 22 MERGER & ACQUISITIONS 14 (May/June 1988).

75. See Johnson, Morris & Williams, *Kohlberg Cuts Buyout Offer for Beatrice*, WALL ST. J., Jan. 9, 1986, at 2, col. 2. The revised offer resulted in a daily debt load for the newco of \$2.1 million, which was 62% more than the company's average daily net income for the prior (pre-MBO) year. See Johnson, *Beatrice Faces Tricky Task in Dismantling its Empire*, WALL ST. J., April 11, 1986, at 12, col. 1.

promising assets, as one observer has suggested; or does the MBO lead to the sale of the "dogs" or the corporate misfits?<sup>76</sup>

On the latter point, one suspects it is not entirely coincidental that the present era of extensive corporate restructurings and asset sales follows an era of extensive conglomerate acquisition. A recent study of thirty-three large diversified U.S. corporations examined their diversification histories during 1950-86 and deemed the results "sobering" and "dismal" on many scores; most of the companies in the study divested more acquisitions than they kept.<sup>77</sup> Indeed, one company included in the study, Beatrice Co., accomplished ninety-seven percent of its entries into new fields and industries through acquisitions of other firms, and by 1980 had divested fifty-nine percent of the acquisitions of unrelated businesses that it had completed to that point.<sup>78</sup> Beatrice's history is significant because, following the period of the study, it executed the largest MBO to date in the United States, and following the MBO the newco divested itself of further assets.

Relatedly, Beatrice's pre-MBO pattern of acquisitions led it to make many purchases of other companies involving steep goodwill charges that are believed to have artificially depressed Beatrice's reported earnings and reduced its stock price.<sup>79</sup> The price paid to public shareholders in the Beatrice MBO, and perhaps others as well, reflects a valuation of the company's assets to which the prior goodwill charges are simply irrelevant, and although the buyout price may appear generous in relation to the stock price, that fact in itself is underwhelming. To the extent that many companies undergoing MBO's have heretofore indulged in widespread conglomerate acquisitions, however, the impact of purchased goodwill on their pre-MBO market price is an additional explanation for the "source" of the premium paid to public shareholders.

In general, then, an MBO creates obligations to creditors that may stimulate asset sales, but the degree to which this creates a stimulus to divest cannot be determined without further empirical study of many such transactions. Analysis of this point is complicated by the fact that transactions drastically increasing corporate debt have recently been proposed by corporate management, as a response to proposals that the corporation divest itself of apparently ill-fitting assets. At stake in the recent contest over Allegis Corp. was the wisdom of management's semi-conglomerate strategy for the corporation, originally known as United Airlines. The corporation's senior management proposed a sixty dollars per share cash distribution to shareholders, which would have added \$3 billion in debt. The pilots' union proposed a seventy dollars per share cash distribution to public shareholders, a spinoff of the airline to employees and shareholders, coupled with a sale of Allegis's hotel and rental car units. Allegis's directors decided to overturn the diversification strategy and sell the assets, perhaps influenced by the fact that Allegis's stock closed

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76. See Coffee, *supra* note 4, at 56-57.

77. Porter, *From Competitive Advantage to Corporate Strategy*, 65 HARV. BUS. REV. 43, 45 (May-June 1987).

78. *Id.* at 50-51.

79. See Smith, *Planned Offer of Some Beatrice Assets Gives Look at Success of Most Leveraged Buyouts*, WALL ST. J., June 5, 1987, at 51, col. 3.

at \$90.75 the day the pilots announced their recapitalization proposal.<sup>80</sup> In short, a policy of asset retention would have been difficult to justify as an enhancement of shareholder value.

Whether the sale of corporate assets is socially less disruptive if it occurs under the aegis of a management-sponsored leveraged transaction than if the sales follow a hostile takeover financed through borrowed funds, cannot be answered satisfactorily at present. The fact that assets are sold does not mean they will not be operated by someone in the future.<sup>81</sup> One factor present in many hostile bids, but not MBO's, is an acquiring party with other business operations. Thus, some hostile transactions may achieve synergistic gains that by definition will not follow an MBO, or may involve the transfer of employees to other operations of the bidder. On the other hand, if hostile acquisition transactions on average result in more highly leveraged operating entities than do MBO's, more sales or other dispositions of assets may follow.<sup>82</sup> Although some observers suspect this to be the case, others do not.

## 2. More Sympathetic

Some commentators believe that MBO's and leveraged recapitalizations tell us a considerably cheerier story. The MBO, by taking the company private, enables its manager-owners to focus on long-term objectives rather than the more immediate response of the stock market and public shareholders. It liberates the firm from the costs of complying with the SEC's reporting requirements for public companies and from the investing public's response to the information it discloses.<sup>83</sup> By significantly enhancing senior management's equity stake, it provides valuable motivation as well. One flaw in this story is the fact that, not too long after many MBO's, public shareholders are once again enlisted as investors. Thus, management's enhanced focus on long-term objectives and elevated motivation may be one-shot occurrences rather than ongoing conditions.

80. See Valente, *Allegis is Sued by Union Chief Over Revamp*, WALL ST. J., June 10, 1987, at 4.

81. Cf. O. Williamson, *Shareholders and Managers: A Risk-Neutral Perspective* 18-19 (Yale Law School Program in Law and Organization, Working Paper # 46, 1986) (observing that monopoly and other social cost exceptions aside, "resources ought to be placed in the hands of highest valuing users").

82. See Coffee, *supra* note 4, at 87 n.231. Further empirical investigation of this point is warranted. Professor Coffee's Article appears to premise its assertion about relative degrees of leverage on the fact that one unsuccessful hostile bid—Turner Broadcasting for CBS—was "the most aggressive use of leverage to date and would, if successful, have given the resulting company a debt to equity ratio of 18:1." *Id.* Even if no MBO approached this level, heavy reliance on the Turner Broadcasting-CBS bid has two key limitations. First, the Turner bid for CBS was unsuccessful. Second, that no proposed MBO has had a projected debt-equity ratio for the newco of the stratospheric dimensions of the Turner-CBS proposal does not establish, on average or *en masse*, the relative debt-equity ratios attributable to proposed or completed hostile transactions versus MBO's.

Furthermore, some LBO transactions severely call into question the relative social disruptiveness of hostile takeover versus management-sponsored buyouts. Burlington Corp., for example, to reduce its LBO debt, sold a key asset to the company whose hostile bid was the trigger for the LBO. See *supra* note 47. And just after its LBO, Burlington's ratio of debt to common shareholders' equity was 29.8 to 1, up from 0.4 to 1 about a year earlier. See Clark & Malabre, *Takeover Trend Helps Push Corporate Debt and Defaults Upward*, WALL ST. J., Mar. 15, 1988, at 1, 28, col. 1.

83. See Borden, *Going Private—Old Tort, New Tort or No Tort*, 49 N.Y.U. L. REV. 987, 1006-08 (1974); cf. Booth, *Management Buyouts, Shareholder Welfare and the Limits of Fiduciary Duty*, 61 N.Y.U. L. REV. 630, 634-35 (1985) (explaining why managers' authority to make the firm's business decisions and establish its payout policy may cause them to value the firm's shares more highly than do passive investors).

A somewhat more sophisticated story—best told by Professor Michael Jensen—emphasizes the difference in legal relationships between corporate managers and shareholders, versus corporate managers and the corporation's creditors.<sup>84</sup> Shareholders do not have the right to compel directors to declare dividends out of any portion of the company's earnings or, for that matter, to require that the firm be managed so as to maximize current earnings. These decisions lie within the directors' discretionary business judgment.<sup>85</sup> Creditors, however, have a contractual right to interest payments as they come due and to timely repayment of the debt's principal amount. If the debtor defaults in either respect, the creditor may sue for enforcement of the contract and may also attempt to place the defaulting corporate debtor in bankruptcy proceedings. If the firm enters bankruptcy, senior management's job tenure—and many other matters as well—will be severely jeopardized.

Thus, in Professor Jensen's view, to the extent a corporation substitutes debt for equity finance, it "bonds" itself to a commitment to pay out future cash flows.<sup>86</sup> Substantial free cash flow can result if the company has few additional internal uses for its funds that will be profitable investments.<sup>87</sup> Investing these funds successfully by acquiring other firms requires specialized skills and, if the acquisition is misguided, will not yield a return in excess of the company's overall cost of capital. Retaining the excess funds may tempt unwarranted and unjustifiable uses. Nonetheless, the company's directors may be reluctant to distribute the funds as a dividend to shareholders due to their fear that, if dividend payments are not maintained at the same level in the future, the stock market will perceive the failure to maintain the dividend rate as a "cut" in dividend and punish the company by reducing the trading price of its stock. Debt's attraction, then, is that it reduces the possibility that free cash flow will be misused; further, it "sets up the required organizational incentives to motivate managers and to help them overcome normal organizational resistance to retrenchment which the payment of free cash flow often requires."<sup>88</sup>

This story, alas, stops too soon. It is true, according to one recent study, that a significant relationship exists between premiums paid in LBO transactions and the firms' pre-transaction undistributed cash flows.<sup>89</sup> But if the corporate debtor repays the principal amount of some substantial portion of its debt, whether through the proceeds of asset sales or the financial results of enhanced operational efficiencies, its "bond" to its creditors for its use of future cash flows is correspondingly reduced.

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84. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance and Takeovers*, 76 AM. ECON. REV. 323 (Papers and Proceedings) (1986).

85. See, e.g., *Kamin v. American Express Co.*, 86 Misc. 2d 809, 383 N.Y.S.2d 807 (Sup. Ct.), *aff'd on opinion below*, 54 A.D.2d 654, 387 N.Y.S.2d 993 (1st Dept. 1976).

86. See Jensen, *supra* note 84, at 324.

87. Professor Jensen defines "free cash flow" as "cash flow in excess of that required to fund all projects that have positive net present values when discounted at the relevant cost of capital." *Id.* at 323. Cash flow, to financial analysts, means a company's net income (after taxes) plus depreciation for the period being measured. In computing cash flow, analysts usually include (in addition to depreciation) the amortization of deferred charges and other major noncash items. Cash flow's greatest contribution to financial analysis is its representation of the cash generated by business operations. This obviously helps meet a company's needs for cash and may thereby reduce or eliminate its need for short or long term loans to finance its present level of operations or to finance expansion.

88. *Id.* at 324.

89. See Lehn & Poulsen, *supra* note 6, at 22.

Jensen's hypothesis may additionally be limited as an account of senior managers' motivations. An MBO gives its equity participants among senior management an opportunity to profit handsomely when public equity investment is once again re-enlisted. Indeed, for senior managers in typically low-growth firms, the MBO may well offer a once-in-a-lifetime opportunity to become seriously rich. This prospect may well tempt some managers to operate the company's business to enhance free cash flow, and thereby enhance the firm's attractiveness as an MBO candidate to prospective financial partners in the transaction.<sup>90</sup> In short, Jensen's argument treats the availability of free cash flow as too much a given, and too little a variable under the control of persons who have much to gain.

#### IV. DIRECTORS' DUTIES

Directors who are presented with a proposal for a management buyout or a leveraged recapitalization should consider carefully the likely complexity of the proponents' motivations. Caution, and on occasion skepticism, is well warranted by recent cases pertinent to directors' obligations in these contexts. In particular, the cases establish that the fact that a transaction was approved by directors who had no personal stake in its completion does not immunize the transaction against close judicial scrutiny of its terms, a scrutiny which may be highly skeptical. Despite the complexity of the context, directors owe to the company duties of care and loyalty, which stated in the abstract do not differ from duties owed to the company under more mundane circumstances. In recent years, however, the judicial formulation of these duties as they apply to the types of transactions under discussion has expected directors to be sensitive to the gravity of the transactions and has declined to defer to assertions that the directors' decisions were mere discretionary "business judgments."

##### A. *Retention of Office*

Directors' desire to retain office is conventionally treated as a motivation that, if it plays a significant part in the directors' approval of a transaction, causes the directors' decision to be self-interested.<sup>91</sup> As a consequence, the directors would have the burden in litigation of establishing the "entire fairness" of the transaction to the corporation. MBO's do not present this risk because they contemplate that, after the buyout, the newco will select its own directors, who will not be directors of the selling corporation, with the exception of prospective equity participants in the newco who serve as directors of the selling company. In contrast, leveraged recapitalizations do not typically contemplate any change in composition of the company's board of directors. If the directors' approval of the transaction is challenged in litigation, they

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90. Free cash flow could be enhanced simply by raising the internal rate of return required to fund new projects. The higher the required rate, the fewer the proposals that will meet it.

91. See, e.g., *Norlin Corp. v. Rooney, Pace Inc.*, 744 F.2d 2255, 2265 (2d Cir. 1984); *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334 (Del. 1987).

will likely be able to articulate some motivation for it in addition to their personal interest in retaining directorships.

The real issue on this score for directors is whether outside directors will choose to continue their membership on the board of a company that has become, by virtue of the transaction, very highly leveraged. To operate a corporation successfully after a massive infusion of debt requires a considerable refocusing of management's attention. Rigorous cost containment may become essential, as may the lucrative sale of substantial assets. Leveraged recapitalizations, because they continue public equity, also continue public disclosure and reporting obligations; management's mistakes as well as successes thus become public information, as does the success with which the directors monitor operating management.

*B. Statutory Liability Arising from Illegal Dividends, Share Repurchases, and Fraudulent Conveyances*

If the corporation becomes insolvent after undergoing an MBO or a leveraged recapitalization, its directors and former shareholders may incur liability to the corporation's creditors or the corporation itself. State corporation statutes subject a decision by directors to distribute assets to shareholders—whether through a dividend or a share repurchase—to a variety of financial tests. In all states, however, the directors' declaration of a dividend is illegal if the effect of paying the dividend is to leave the corporation unable to pay its debts as they come due.

Under the Delaware statute, directors are "fully protected in relying in good faith upon the books of account or other records of the corporation" prepared by its officers or by independent public accountants or appraisers as to the value and amount of the corporation's assets, liabilities, and net profits, and as to other facts pertinent to the decision.<sup>92</sup> But if directors "willfully or negligently" cause the corporation to repurchase shares or declare a dividend in violation of the statutory restrictions, they are liable to the corporation, and to its creditors in the event of its insolvency, "to the full amount of the dividend illegally paid, or to the full amount unlawfully paid for the purchase or redemption of the corporation's stock, with interest from the time such liability accrued."<sup>93</sup>

Fraudulent conveyance law enables creditors to set aside a debtor's transaction if, as a result of the transaction, the debtor is or would be rendered insolvent and the conveyance was made or the obligation incurred without fair consideration.<sup>94</sup> Such transactions are deemed fraudulent without regard to the actual intention of the debtor or creditor.<sup>95</sup> If the transaction has been completed, a creditor with a matured claim may have the conveyance of property set aside to the extent necessary to satisfy the claim, or may disregard the conveyance and attach or levy execution on the property

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92. DEL. CODE ANN., TIT. 8, § 172 (1987).

93. *Id.* § 174(a).

94. See *United States v. Tabor Court Realty Corp.*, 803 F.2d 1288, 1296–97 (3d Cir. 1986) (mortgages executed to lender in connection with LBO set aside as fraudulent conveyances).

95. *Id.* at 1296. The breadth of fraudulent conveyance law's treatment of "constructively fraudulent" transfers is not reached by *Tabor Court* because the Third Circuit affirmed the district court's finding that the conveyance of the mortgage was intentionally fraudulent. See *id.* at 1295–96, 1297 n.3.



conveyed.<sup>96</sup> Thus, as applied to the transactions under discussion, fraudulent conveyance law enables a corporation's creditors to pursue the transferees of its assets, including former shareholders, as well as lenders who receive security interests in its assets and their assignees.<sup>97</sup>

A more technical concern for directors who authorize a leveraged recapitalization stems from the statutory regulation of share repurchases and redemptions, beyond the insolvency limitation discussed above. Under the Delaware statute, a corporation may not "purchase or redeem" its own shares for cash or other property when the capital of the corporation is impaired or would become impaired due to the transaction.<sup>98</sup> Capital impairment, under this statute, results from an excess of liabilities plus stated capital (the par or stated value of shares) over the value of the corporation's assets.<sup>99</sup> If the fair market value of a corporation's assets exceeds their book value, and the transaction is priced to reflect fair market value, then either capital will be impaired as a result of the transaction, or the directors will desire to "write up" the assets' value. Accountants frown on writing up asset values in connection with recapitalizations because they are accounted for as redemptions rather than as purchases. Corporate law, at least in Delaware, is thought to be splendidly indifferent to these niceties of accountancy and would permit a corporation's directors to revalue assets and liabilities to effect a redemption.<sup>100</sup>

### C. Stand-Alone Transactions

In analyzing directors' duties in this context, it is helpful to begin with proposed transactions that do not follow third party bids and do not otherwise seem responsive to threats to corporate control. Additional considerations, discussed below, become pertinent when these transactions are deployed defensively or when a competing proposal is made by a third party. A pervasive concern, however, is the same: the directors' ability to discourage—or conversely their obligation to encourage—competing offers.

The most elaborate exposition of directors' duty of care in responding to a proposed LBO appears in *Smith v. Van Gorkom*,<sup>101</sup> a 1985 opinion from the Delaware Supreme Court that is not without its critics.<sup>102</sup> The LBO proposal—which apparently

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96. See UNIF. FRAUDULENT CONVEYANCE ACT §§ 4, 9(1) 7A U.L.A. 577 (1985). The Federal Bankruptcy Act contains its own fraudulent conveyance provisions. See 11 U.S.C. § 548 (Supp. 1987).

97. See Note, *Fraudulent Conveyance Law and Leveraged Buyouts*, 87 COLUM. L. REV. 1491, 1513 (1987); but cf. Baird & Jackson, *Fraudulent Conveyance Law and its Proper Domain*, 38 VAND. L. REV. 829, 850-54 (1985) (advocating narrow application of fraudulent conveyance law to LBO's). See generally Murdoch, Sartin & Zadek, *Leveraged Buyouts and Fraudulent Transfers: Life after Gleneagles*, 43 BUS. LAW. 1 (1987); Kirby, McGuinness & Kandel, *Fraudulent Conveyance Concerns in Leveraged Buyout Lending*, 43 BUS. LAW. 27 (1987); Sherwin, *Creditors' Rights Against Participants in a Leveraged Buyout*, 72 MINN. L. REV. 449 (1988).

98. DEL. CODE ANN. TIT. 8, § 160(A)(1) (1983).

99. *Id.* § 154.

100. The Delaware case most directly supporting this practice is *Morris v. Standard Gas & Elec. Co.*, 31 Del. Ch. 20, 63 A.2d 577 (1949). In *Morris*, the court upheld the legality of dividends declared on the basis of an asset revaluation; the directors, in the court's view, "took great care to obtain data on the point in issue, and exercised an informed judgment on the matter," even though they did not obtain a formal appraisal of each of the assets. *Id.* at 36, 63 A.2d at 585.

101. 488 A.2d 858 (Del. 1985).

102. See, e.g., Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. LAW. 1437 (1985).

did not contemplate any equity stake in the newco for present members of the company's senior management—was presented on September 20, 1980, to the directors of Trans Union Corp. along with the strong endorsement of its chairman and CEO, Mr. Van Gorkom. It contemplated a merger transaction in which Trans Union's shareholders would receive fifty-five dollars per share in cash (for a total cash payout of \$690 million), which represented a sixty-two percent premium over the average of the high and low prices at which Trans Union's stock traded in 1980. Trans Union's ten directors, half of whom were outsiders, approved the merger proposal after one two-hour meeting, following an oral presentation from Mr. Van Gorkom, and oral statements from the company's chief financial officer and from a lawyer engaged by Van Gorkom to advise Trans Union.<sup>103</sup>

*Smith v. Van Gorkom* was a class action brought on behalf of all persons—other than the defendants—who owned Trans Union stock on the relevant dates. The Delaware Supreme Court held that Trans Union's directors were grossly negligent and were liable for money damages to the corporation's shareholders. As the plaintiff agreed, following the trial but prior to the trial court's decision, to the dismissal with prejudice of the owners of Trans Union's merger partner as defendants, the supreme court did not have occasion to consider their liability.<sup>104</sup>

Much is made in the court's opinion of events that did *not* occur at the two-hour directors' meeting. Although the directors were familiar with the market history of Trans Union's stock, they were not told the basis for the fifty-five dollar price; Mr. Van Gorkom did not volunteer the information and no one asked for it. Indeed, the directors were not told that fifty-five dollars was Van Gorkom's number, not the buyer's and not the product of negotiations over price with the buyer. The fifty-five dollar number first surfaced when Trans Union's chief financial officer raised the idea of a management buyout with Van Gorkom; although Van Gorkom rejected the MBO idea "as involving a potential conflict of interest for management,"<sup>105</sup> he stated he would be willing to sell his own 75,000 shares for \$55/share. He later determined, with the assistance of Trans Union's controller, that a price of \$55/share would enable a buyer to structure the acquisition as an LBO and substantially repay the LBO debt within five years out of cash generated by Trans Union's operations.

In the court's view, to discharge their duty of care to the corporation, directors must have some factual basis for believing that the price offered by the transaction adequately reflects the company's true value. Trans Union's directors, however, did not even know *how* the LBO price was determined and could even have assumed that the price was the result of arms-length negotiations between Mr. Van Gorkom and the buyer. Likewise, although the LBO price represented a premium over market price,

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103. One of the many curious aspects of this case is that, although the defendants claimed they relied on legal advice given by the lawyer at this meeting, he himself did not testify at the trial despite his firm's participation in the defense of the action. See 488 A.2d at 880.

104. *Id.* at 864 n.1. The plaintiff originally sought an injunction against the merger. One week after the court denied the plaintiff's motion for a preliminary injunction, the proposed merger was approved by Trans Union's shareholders. Thereafter the action was certified as a class action, see *id.*, and the plaintiffs sought rescission, with damages as an alternate form of relief. *Id.* at 863.

105. 488 A.2d 858, 865.

Trans Union's directors were of the view that the stock market had consistently undervalued the company's worth, and no other valuation information was presented to the directors or requested by them. The directors' statutory right to rely in good faith on reports made by the company's officers<sup>106</sup> is similarly unavailing, because Van Gorkom's oral presentation, even treated as a "report," was too brief and uninformed to relieve the directors of an obligation to inquire further. Although critics of *Smith v. Van Gorkom* sometimes assert that the opinion is an "Investment Bankers' Relief Act" because it requires an outside valuation study to support the directors' decision, this claim is not supportable. The opinion expressly makes the point that insiders familiar with a business may well be able to produce information about value upon which directors may justifiably rely.

The directors were likewise not provided with a copy of the proposed merger agreement, nor does it appear that the implications of key provisions in the agreement were accurately described to the board. Van Gorkom—who himself had not seen the merger agreement—told the directors that for a period of ninety days, Trans Union could receive but not actively solicit competing bids, and could furnish to these bidders publicly available but not proprietary information. The effect of these limitations undercuts the defendants' argument in litigation that the directors' approval of the transaction on September 20 was conditioned on a "market test" of the LBO price.

After the deal was publicly announced, senior management revolted *en masse*, leading to a second board meeting at which the directors approved what Van Gorkom represented to be amendments to the merger agreement that would enable Trans Union to conduct the "market test." The board approved the amendments sight unseen and thus unread, and, as it happened, the amendments, if anything, reduced the prospect of a competing offer by narrowly defining the transactions that would permit Trans Union to withdraw from the merger agreement.<sup>107</sup>

*Smith v. Van Gorkom* does not permit directors to abdicate their duty to shareholders to exercise informed judgment, relying on the fact of shareholder approval to foreclose judicial scrutiny of their decision. Although an informed shareholder vote can effectively ratify director action that is otherwise vulnerable to legal attack, this point is a bit academic because Trans Union's proxy materials were far from candid in their presentation of information to shareholders. The shareholders were not told of the directors' lack of valuation information, of the origins of the fifty-five dollars per share price, and of other matters deemed highly pertinent by the court to an informed shareholder vote.

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106. See DEL. CODE ANN., tit. 8, § 141(e) (1983).

107. The defendants' posture in the litigation was not aided by their failure to produce the original merger agreement, despite plaintiffs' demands for its production before and during trial. The amended agreement enabled Trans Union to withdraw only if, within four months, it had either consummated a merger or sale of assets transaction with a third party or had entered into a "definitive" merger agreement, subject only to shareholder approval, more favorable than the LBO deal and for a greater consideration. The earlier agreement apparently permitted Trans Union to withdraw from the merger agreement if it received a better offer. See 488 A. 2d at 883. But see Van Gorkom, *The Defendant's Side of the Trans Union Case*, 22 MERGERS & ACQUISITIONS 51, 52 (Jan./Feb. 1988) (characterizing directors' approval of merger agreement as merely a mechanism to preserve offer for shareholders and to set in motion a public auction).

*Smith v. Van Gorkom* is controversial, in this writer's view, because it is one of a very few cases holding directors liable for breaches of their duty of care, even though uncompounded by self-dealing or evident self-interest in any form. Indeed, one of the perplexing mysteries of the case is Van Gorkom's own motivation; while his large shareownership meant he potentially had much to gain from a sale at a premium price, it fails to explain his persistence in concluding a transaction that may well have offered a lower price than the price available from other potential buyers.

In any event, a provision widely perceived to be a response to the case was added to Delaware's General Corporation Law in 1986. Section 102(b)(7) now permits provisions in certificates of incorporation "eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for a breach of fiduciary duty as a director," excepting breaches of the duty of loyalty, acts not in good faith or involving intentional misconduct or knowing violations of the law, transactions from which the director derived an improper personal benefit, and liability arising from the unlawful payment of dividends or unlawful share repurchases. This statutory provision is obviously not a legislative overruling of *Smith v. Van Gorkom*. Charter provisions authorized by the statute cannot eliminate the duties directors owe to corporations, nor can they redefine the acts that constitute breaches of those duties. Nor does the statute's enabling provision affect the availability of injunctive or rescissory relief or, for that matter, the availability of monetary damages against third parties who benefit from the directors' breach.<sup>108</sup>

Wholly apart from the question of their ultimate legal liability for damages, directors presented with a buyout proposal may take steps to make their response more credible. Several courts have endorsed the use of committees of independent directors to evaluate and negotiate the terms of the proposed transaction whenever present senior management will have an ownership stake in the resulting entity,<sup>109</sup> or the selling corporation is controlled by its prospective partner in the transaction.<sup>110</sup> If the independent directors' committee chooses to enlist the advice of a source of financial advice external to the corporation, retaining an investment firm without a stake in the approval or consummation of the transaction has much to commend it.<sup>111</sup>

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108. See RESTATEMENT OF THE LAW OF RESTITUTION § 1, 138(2) (1937). The basic principle stated in § 1 is that "a person who has been unjustly enriched at the expense of another is required to make restitution to the other." The pertinent definition of "unjust enrichment," stated in § 138(2), is that "[a] third person who has colluded with a fiduciary in committing a breach of duty, and who obtained a benefit therefrom, is under a duty of restitution to the beneficiary." How the "collusion" concept applies to a negotiated merger transaction awaits further development. One wonders how extensive the third party purchaser's knowledge of the breach of duty must be to constitute "collusion." Is the purchaser free from liability under this principle if it cautions persons acting on behalf of the seller that they may be breaching their fiduciary duties? See generally G. PALMER, 1 LAW OF RESTITUTION 141-49 (1978).

109. See *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264, 277 (2d Cir. 1986).

110. See *Weinberger v. UOP, Inc.*, 457 A.2d 701, 709-10 n.7 (Del. 1983).

111. In *Edelman v. Fruehauf*, 798 F.2d 882, 885 (6th Cir. 1986), a special committee of Fruehauf's outside directors, appointed to consider a proposed MBO, employed as its advisor the investment bank that concurrently was negotiating the MBO's terms on behalf of management and that "clearly favored" the MBO over other alternatives. The court's opinion treats the investment bank's dual role as an indicium of the directors' intention to preempt the bidding in favor of management and the MBO. *Id.* The fee structure for the investment bank's compensation may also be relevant to the credibility of its advice. If the fee includes an "independence bonus," payable only if a hostile bid is defeated, or if it includes an incentive increment if a transaction is concluded with a party friendly to incumbent management, a court

When directors recommend approval of a corporate control transaction to their shareholders, the common practice—obviously not followed in *Smith v. Van Gorkom*—is to communicate to the shareholders an investment banker's opinion as to the fairness of the transaction.<sup>112</sup> In a rough sense, the opinion, if it is based upon a thoughtful assessment of relevant non-public information about the company, is a surrogate for full disclosure to both the shareholders and the market generally, as a basis on which to assess the adequacy of the price being offered. Although fairness opinions appear more rather than less credible if the investment banker giving the opinion is not compensated on an outcome-contingent basis, generally investment bankers' fees in this connection are larger if the opinion asserts that the transaction is fair and smaller if the opinion asserts that the price offered is financially inadequate. "Inadequacy" or unfairness opinions cost less than "fairness" or adequacy opinions because part of the fee is in effect an insurance premium against the risk of litigation against the investment bank. If the banker concludes that the proposed price is inadequate, it is likely that either the transaction will not occur, or if it occurs, a higher price will be offered. Non-transactions are inherently less conducive to litigation than transactions, and thus require less of an insurance premium.

Communications from corporations to their shareholders concerning such transactions are required by Delaware law to be completely "candid,"<sup>113</sup> and by the federal securities laws and the SEC's proxy rules to state all "material facts." In addition, the disclosure requirements of the SEC's "going private" rule must be met.<sup>114</sup> Cases applying the Delaware standard interpret it to require disclosure of any significant limitations on non-public corporate information furnished to the financial advisor and of impediments to the thoroughness of the investment banker's assessment of the information provided, such as an extremely short period of time in which to conduct the review.<sup>115</sup> Relatedly, the court's response to the facts in *Smith v. Van Gorkom* is not sympathetic to directors' abbreviated reactions to offers that require a rapid reply. The prospective buyer for Trans Union told Mr. Van Gorkom that he had to have a decision within three days, a short fuse that Van Gorkom communicated to the directors. The opinion observes that Trans Union's directors considered neither recessing their meeting—held the day after the offer was communicated to Van Gorkom—to obtain more information about the sufficiency of the offer, nor requesting an extension of the deadline set by the offeror for their response. At a minimum, directors who receive a short-fused proposal, if they cannot

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may be troubled and may become suspicious of the adequacy or appropriateness of the independent directors' procedures. See *Dynamics Corp. of Am. v. CTS Corp.*, 850 F.2d 705, 710–11 (7th Cir. 1986), *rev'd on other grounds*, 107 S. Ct. 1637 (1987).

112. See generally Note, *Investment Bankers' Fairness Opinions in Corporate Control Transactions*, 90 YALE L.J. 119 (1986).

113. See *Lynch v. Vickers Energy Corp.*, 383 A.2d 278 (Del. 1978).

114. 17 C.F.R. § 240.13e-100 (1987).

115. See *Weinberger v. UOP, Inc.*, 457 A.2d 701, 712 (Del. 1983) (failure to disclose cursory and hurried preparation of fairness opinion); *Kahn v. United States Sugar Corp.*, No. 7313 (Del. Ch., Dec. 10, 1985), *reported in* 11 DEL. J. CORP. L. 908 (1986) (failure to disclose, *inter alia*, that contrary to impression given to shareholders, investment banker never was allowed to do an independent or thorough valuation study).

develop an adequately-informed response within the constraint set by the offeror, are obliged to pursue the possibility of an extension.

The credibility of a negotiated price is enhanced if no competing proposal offering superior consideration emerges and if the negotiated agreement has not been structured to inhibit or foreclose competing proposals. The "no-shop" commitment given to the buyer in *Smith v. Van Gorkom*, in the court's view, severely restricted the possibility that a competing offer would be made. But although the court concluded that the directors could thus not rely on a "market test" of the price to establish that they acted in a sufficiently informed fashion in approving the transaction, its opinion in *Smith v. Van Gorkom* is far from a categorical denunciation of "no-shop" clauses.

Other cases raising the question more directly have reached somewhat conflicting assessments of the acceptability of "no-shop" commitments. The federal Court of Appeals for the Ninth Circuit, applying California law, held that directors had power to enter into an "exclusive merger agreement" and to commit to the merger partner that they would "use [their] best efforts to fulfill those conditions . . . over which [they have] control or influence and to consummate the Merger.'" <sup>116</sup> Despite the statutory requirement of shareholder approval for the merger, the court held that a third party that made a competing bid subsequent to the public announcement of the merger agreement tortiously interfered with an immediate binding contract between the merger partners. Other cases, however, have concluded that directors lack contractual power to bind the corporation to a merger agreement without shareholder approval;<sup>117</sup> further, if the merger agreement contains "fiduciary out" language permitting directors to withdraw their endorsement of the proposal if their fiduciary obligations to shareholders so dictate, a "best efforts" commitment from the directors in the same agreement does not oblige them to continue to endorse the deal if a superior offer emerges.<sup>118</sup> Even in the absence of inhibitions of this sort created by the merger agreement, competing offers are more likely to be made if they are actively elicited and nurtured with the provision of non-public information about the company.

One might think that competing bids would be especially inhibited by extensive financial commitments made to the prospective purchaser, such as large cancellation fees and options to buy the target corporation's most valuable assets. Competing bidders, however, have enjoyed considerable success in challenging lock-up options in litigation,<sup>119</sup> and that fact appears to inhibit their use somewhat; on the other hand, the plaintiffs in these successful challenges have all been competing bidders, and in the absence of a stalwart competitor, lock up options may as a practical matter be less vulnerable to attack.

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116. *Jewel Corp. v. Pay Less Drug Stores Northwest*, 741 F.2d 1555, 1557 (9th Cir. 1984).

117. *See Conagra, Inc. v. Cargill, Inc.*, 382 N.W.2d 576, 588 (Neb. 1986) (applying Delaware law).

118. *Id.* at 587.

119. *See infra* notes 139-43 and accompanying text.

Leveraged recapitalizations—at least in the absence of competing proposals—raise fewer vexing issues concerning directors' duties, in large measure due to the formal nature of the transactions involved. A leveraged recapitalization does not involve the prospective sale of the company's assets or all of its shares to another entity, and thus the issues generated by the selling corporation's relationships to and agreements with the purchasing entity are not present. If the effect of the transaction, however, is to change voting control of the corporation, then the directors may be obliged to act solely to obtain the highest price for the corporation's shareholders.<sup>120</sup> In *Black & Decker Corp. v. American Standard Inc.*, discussed more fully below, the court held that such a standard was applicable to directors' decisions when the directors approved a leveraged recapitalization that conferred voting control of the corporation on its management and an ESOP.<sup>121</sup> To be sure, directors in any event have an obligation to inform themselves adequately prior to approving a leveraged recapitalization and, if the transaction requires shareholder approval, to comply with the "complete candor" standard of disclosure.<sup>122</sup> If the recapitalization includes an issuer tender offer or exchange offer, the transaction must comply with the applicable set of tender offer rules.

#### D. Contested and Defensive Transactions

In most jurisdictions, the nature of directors' duties to the corporation—or the judicial standard applicable to reviewing whether those duties have been fulfilled—does not metamorphose when the directors act in response to a threatened change in corporate control or otherwise find themselves in the midst of a bidding battle for control of the company. If the directors have no personal interest in the transaction, and their approval of it can be characterized as an exercise of informed judgment, a court asked to review the merits of the directors' decision will decline to do so. In contrast, in Delaware a two-step standard of review is applicable to the directors' authorization of defensive transactions or other steps designed to defeat a threatened change in corporate control, due to the "omnipresent specter that a board *may* be acting primarily in its own interests."<sup>123</sup> First, the directors must show that they had a reasonable basis for believing in the existence of a threat to corporate control or "corporate policy and effectiveness."<sup>124</sup> The chancellor's opinion in *AC Acquisitions Corp. v. Anderson, Clayton & Co.* formulates this part of the standard somewhat

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120. See text accompanying notes 146–51 *infra*.

121. Nos. 88–50, 88–104 (D Del. Mar. 16, 1988) (1988 U.S. Dist. LEXIS 2680).

122. Valuation disputes, and thus disputes over the adequacy of disclosure, are likely to concentrate on the projected value of the stub shares. See *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103, 113 (Del. Ch. 1986). Relatedly, the chancellor in *Anderson, Clayton* took the position that under Delaware law an issuer's failure to disclose "soft information"—such as financial projections and asset appraisals—could only be assessed on a case-by-case basis and that no categorical rule protected an issuer's failure to disclose such information. See *id.* at 692. Compare *Starkman v. Marathon Oil Co.*, 772 F.2d 231 (6th Cir. 1985) (federal law does not generally require disclosure of soft information in proxy or tender offer material due to inherent unreliability of soft information) with *Flynn v. Bass Bros. Enters., Inc.*, 744 F.2d 978 (3d Cir. 1984) (case-by-case determination of issuer's obligation under federal law to disclose soft information).

123. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985).

124. *Id.* at 955.

differently: whether the directors had a basis to conclude that "a proper corporate purpose" would be served by implementing the transaction.<sup>125</sup> Second, the defensive measure chosen by the directors must be found by the court to be "reasonable in relation to the threat posed by the change in control that instigates the action."<sup>126</sup>

To date, only in the *Anderson, Clayton* litigation has the application of this standard of review led a court to grant preliminary injunctive relief against a defensive transaction. *Anderson, Clayton's* directors, following a fifty-six dollars per share cash tender offer for all shares from a third party, authorized a sixty dollars per share cash issuer tender offer for approximately sixty-five percent of its outstanding shares. The company announced at the same time a plan to sell stock to a newly-formed ESOP in an amount equal to about twenty-five percent of all issued and outstanding stock following the sale. The court held that the directors established that they adopted this plan to serve a valid corporate purpose: to give the shareholders an alternative to the third party tender offer, an alternative that enabled its shareholders to retain an equity interest in the company. Even though the directors had no basis for believing the third party offer to be coercive or unfair—*Anderson, Clayton's* investment banker was unable to state that fifty-six dollars per share in cash for all shares was an inadequate price—the court held that the directors' creation of an alternative served a valid corporate purpose, especially since the opportunity was made available to all shareholders on the same terms.

The directors' response nonetheless was fatally flawed because it was coercive, and this characteristic precluded the court from determining that the directors' action was reasonable in relation to the threat posed. The transaction was coercive, in the court's view, since no rational shareholder would choose not to tender into the company's self tender because even shareholders who would prefer to sell all their shares for cash to the third party bidder would not tender to it. The third party's offer was conditioned on, among other things, the tender of a minimum number of shares and the issuer's abandonment of its transaction; shareholders who tendered to the third party thus risked, if that bid failed, losing the opportunity to sell any of their shares to the company for sixty dollars per share in cash. And while the third party was under no legal duty to extend an unconditional offer, the directors were obliged to exercise judgment to promote the shareholders' interests.<sup>127</sup> As the directors had not determined the third party bid to be unfair or inadequate, their coercive response was unwarranted by the applicable criterion of acting to further the shareholders' interests.

As it happens, *Anderson, Clayton's* proposed self-tender transaction followed a prior attempt to implement a recapitalization plan, which had earlier been enjoined by the same court. The impending expiration of family trusts holding 27.3 percent of the company's outstanding stock prompted in part the proposal to recapitalize.<sup>128</sup> After

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125. 519 A.2d 103, 112 (Del. Ch. 1986).

126. 493 A.2d 946, 955 (Del. 1985).

127. *Id.* at 114 n.12. Takeover regulation in the United States does not restrict a bidder's ability freely to condition its bid. In other jurisdictions with active takeover markets, bidders' conditions are regulated to one degree or another. See DeMott, *Comparative Dimensions of Takeover Regulation*, in *KNIGHTS, RAIDERS & TARGETS: THE IMPACT OF THE HOSTILE TAKEOVER* (J. Coffee, L. Lowenstein & S. Rose-Ackerman eds. 1988).

128. See *In re Anderson, Clayton Shareholders' Litig.*, 519 A.2d 669 (Del. Ch. 1986).



Anderson, Clayton publicly announced its leveraged recapitalization plan, but before the company's shareholders voted on it, Anderson, Clayton received an unsolicited proposal for a cash merger at fifty-four dollars per share from the same group that eventually made the tender offer described above. The merger proposal was not warmly welcomed by Anderson, Clayton's management, and little discussion or negotiation with the would-be merger partner occurred.<sup>129</sup>

Despite this fact, the company distributed to its shareholders a supplement to its proxy statement recommending that they vote for the recapitalization, but asserting that representatives of the company were "continuing to discuss" the merger proposal with its proponents' representatives.<sup>130</sup> The court enjoined the recapitalization because the supplemental proxy statement did not accurately describe the position that Anderson, Clayton's directors apparently had taken on the merger proposal, which was that they had no interest in pursuing the matter. Thus, shareholders might well have approved the recapitalization in the belief that the directors would ultimately enable the emergence of a merger agreement offering fifty-four dollars per share in cash.

Of special interest is the court's analysis of the propriety of the directors' preference for the recapitalization plan, for it suggests that, had the proxy statement accurately described the directors' reaction to the merger proposal, a shareholder vote approving the recapitalization would have decisively concluded the matter. The court observed that, under Delaware law, directors have no obligation to delay "an otherwise appropriate transaction" because of the last-minute emergence of an alternative that might, if pursued, be more advantageous to the corporation or its shareholders.<sup>131</sup> Directors are nonetheless obliged "to explore and evaluate alternatives" to their favored transactions at least when the transaction is so significant that it requires a shareholder vote.<sup>132</sup> But these alternatives, after due exploration, may be rejected if a rational shareholder or director could prefer the recapitalization deal to an all-cash alternative. On the other hand, as the later Anderson, Clayton litigation establishes, directors may not structure their preferred alternative to coerce shareholders into it if the disfavored alternative is not itself coercive or unfair.

Various aspects of the Anderson, Clayton proposals are troubling. At the time it announced the recapitalization plan, the company's management claimed that through its investment banker it had already conducted a diligent search for a buyer, and that although thirteen prospects had been contacted, no offers had been received.<sup>133</sup> The credibility of this claim is undercut by management's inability even to work out a confidentiality agreement with the group advancing the merger proposal,<sup>134</sup> and by the investment banker's failure to contact an obvious prospect,

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129. *Id.* at 683.

130. *Id.* at 673.

131. *Id.* at 676.

132. *Id.* at 676.

133. See Petzinger, *Anderson Clayton Recapitalization Plan Draws Opposition by Several Big Holders*, WALL ST. J., May 1, 1986, at 6, col. 2.

134. See 519 A.2d 669, 673 (Del. Ch. 1986). Although Anderson, Clayton claimed that substantive negotiations had not proceeded because the merger proponent was unwilling to agree to confidentiality in an undertaking, in the court's

Quaker Oats, which did ultimately acquire Anderson, Clayton.<sup>135</sup> But Quaker Oats had earlier crossed the path of Anderson, Clayton's president and CEO. Prior to joining Anderson, Clayton, he was an executive vice president at Quaker but left in 1976 after a rival became chairman.<sup>136</sup> Against this background, the acquiescence of Anderson, Clayton's directors in the recapitalization plan, in a misleading description of the plan to sell it to the shareholders, and in the coercive self-tender strategy, is disturbing.

A related issue is whether a management-sponsored proposal may be withdrawn, and a "not for sale" sign placed on the company, if a third party offers a manifestly better price than the management-sponsored transaction. For example, after members of management and of the founding families of Multimedia, Inc. proposed an LBO merger that would give public shareholders a package of cash and debt securities valued at \$49.50 per share, a third party offered to acquire the company through a merger in which shareholders would receive in cash sixty dollars per share. Multimedia subsequently announced that the family group had determined that it had no interest in selling the company and that it was instead committed to a leveraged recapitalization proposal that had been developed after third parties expressed interest in acquiring the company.<sup>137</sup>

Likewise, it is apparent that management's disinclination to participate in a proposed transaction, and its assertion of preference for an alternative, can effectively shape the directors' assessment of competing proposals. For example, the directors of Jim Walter Corp. signed an agreement to be acquired for \$2.44 billion in an MBO led by Kohlberg, Kravis Roberts & Co. (KKR), despite having received an MBO proposal at a higher price (\$2.52 billion) from Paine Webber Inc. Although Paine Webber originally offered \$2.8 billion, its offer was lowered after discussions with company officials. The directors' stated rationales for endorsing instead KKR's lower offer, raised by KKR from its initial offer of \$2.03 billion, were that Paine Webber's offer was "too aggressive" and that the company's management would not participate in the transaction.<sup>138</sup> Assuming, however, that Paine Webber could credibly assure the directors of its ability to assemble the financing for the transaction,<sup>139</sup> and that the transaction's effects would not cause it to be characterized

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view "it now appears that the hang-up on this front has nothing to do with confidentiality, but rather with the Company's insistence that [the merger proponent] enter into a standstill agreement. . . ." Under the Company's proposed standstill agreement, the merger proponent "would not be permitted to 'initiate, instigate or join in any litigation challenging [the Company's] pending recapitalization transaction or otherwise to interfere with the recapitalization transaction.'" *Id.*

135. See Johnson & Solis, *Quaker Oats Buys Anderson Clayton Stake*, WALL ST. J., Sept. 26, 1986, at 2, col. 2.

136. See Johnson & Solis, *Quaker Wins Bid for Control of Anderson*, WALL ST. J., Sept. 29, 1986, at 2, col. 2.

137. See Lipton, Mirvis & Brownstein, *Takeover Defenses and Directors' Liabilities* 3, 66-67, in 1 TAKEOVER DEFENSES AND DIRECTORS' LIABILITIES: RESOURCE MATERIALS (M. Lipton ed. 1986).

138. See Cohen, *Jim Walter Sets Buy-Out Pact for \$2.44 Billion*, WALL ST. J., Aug. 14, 1987, at 3, col. 1.

139. Doubt as to the credibility of Paine Webber's financing was expressed by Jim Walter officials, while the investment banker advising the committee of Walter's independent directors who evaluated the proposals stated that the KKR proposal was "more credibly financed." *Id.* Although Paine Webber had not yet paid banks for formal commitment letters assuring it of their participation in the requisite loans, its director of investment banking stated that he assured Walter's investment banker that Paine Webber would get the commitment letters quickly if it believed Walter was willing to negotiate with Paine Webber. Another investment banker, at Citibank, which had agreed to lend \$500 million to Paine Webber and to put together a bank syndicate to lend another \$1.5 billion, states that it is customary for a bidder not to have a commitment letter from a bank in hand prior to bidding due to the "hefty" fees charged by the banks. *Id.*

as a fraudulent conveyance, the interests of the company's public shareholders are linked neither to the post-MBO leverage of the newco nor to the subsequent restructurings and asset sales that the debt burden may necessitate.<sup>140</sup> But these matters are inexorably linked to the value of the newco equity to be received by participating members of the selling company's management.

At some point, however, recent cases recognize that the corporation's directors have an obligation to see that their shareholders receive the best price possible for their stock. In *Edelman v. Fruehauf Corp.*,<sup>141</sup> the federal Court of Appeals for the Sixth Circuit, applying Michigan law, identified the point as the time when "it becomes apparent that a takeover target will be acquired by new owners."<sup>142</sup> A slightly different formulation appears in the Delaware Supreme Court's opinion in *Revlon, Inc. v. MacAndrews & Forbes Holdings*<sup>143</sup>: the inevitability of the company's break-up, and the directors' recognition that the company is for sale.<sup>144</sup> Thereafter, the directors' role metamorphoses into one of neutral auctioneering, and directors breach their duty to shareholders if they take measures that are intended to end the bidding.

These cases, applying this test, invalidate the grant to favored bidders of options to buy significant target assets. They also severely restrict the target's ability to furnish financial assistance to the favored contestant. Even if the directors' role undergoes no formal metamorphosis, if directors in the midst of a bidding contest grant a lock-up option to sponsors of an MBO, then exercise of the option may be enjoined if the directors failed to fully inform themselves about the value of the assets and of the option transaction because the directors' decision to grant the option facilitates a transaction in which management has a strong self-interest.<sup>145</sup>

A difficulty with the analysis in *Edelman* and *Revlon* is that much hinges on the determination of when a company goes "into play" and "up for sale." The Multimedia episode illustrates that MBO proponents may wish first to assess—but only on their terms—whether a transaction will meet with competition before the company commits itself to a professed interest in being sold. Then prior to posting the "for sale" sign, directors may take steps to ensure the success of a management-sponsored transaction.

A further limitation of this analysis is its striking permissiveness as applied to leveraged recapitalizations. So long as a leveraged recapitalization does not count as a "sale" of the company, directors' endorsement of a proposal for a leveraged

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140. Another interesting facet of the Jim Walter transaction is the use of unusual asset-backed securities for long term financing for the LBO. To replace a \$2.3 billion bank line of credit arranged in September 1987, in December the company announced a plan to market through a private placement \$1.3 billion in debt securities backed by mortgages on company-built houses. Using its customer receivables in this way enabled Jim Walter to halve the amount of junk bonds otherwise needed to finance the LBO. Furthermore, the asset-backed securities were expected to carry yields substantially below those on the remaining junk bond component. See Monroe, *Jim Walter Turns to Unusual Method of Long-Term Financing for Buy-Out*, WALL ST. J., Dec. 30, 1987, at 2, col. 5.

141. 798 F.2d 882 (1986).

142. *Id.* at 886.

143. 506 A.2d 173 (Del. 1986).

144. *Id.* at 182.

145. See *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264, 284 (2d. Cir. 1986) (Oakes, J., concurring) (applying New York law).

recapitalization is not a determination by the company's directors that metamorphoses their role into one of neutral auctioneering. For example, if the leveraged recapitalization involves the issuance of debt securities, the issuer's directors are under no obligation to ease the travails of a hostile leveraged bidder by waiving any restrictive covenants contained in the debt securities, even if so doing would enhance the choices available to the issuer's shareholders.<sup>146</sup> Only when the "inevitability of sale" point is reached does *Revlon* require directors to focus primarily on achieving benefits for equity holders. Arguably then, if the debt securities permit the protective covenants to be waived, the directors may be obliged to do so if their shareholders will benefit thereby.<sup>147</sup> Especially if the leveraged recapitalization shifts effective control of the company to management and its dependable allies (like ESOP's), to insist that the directors' decisions should be evaluated in isolation from competing alternatives because no "sale" has occurred is to elevate form over financial and behavioral reality.

Thus far, only one court has applied the *Revlon* standard in a leveraged recapitalization context. The federal district court in *Black & Decker Corp. v. American Standard, Inc.* held that, if presented with the same facts, the Delaware Supreme Court would apply the *Revlon* principle to them.<sup>148</sup> After a cash tender offer by Black & Decker for any and all American Standard shares, American Standard's directors approved a recapitalization plan that, subject to shareholder approval of the plan itself, potentially allocated 55.5% of the company's shares to its senior management and a newly-created ESOP. This potential would be realized if all outstanding options were exercised; in its news release describing the plan to the general public, American Standard explained its effect on voting control on a fully diluted basis, assuming that all options would be exercised.<sup>149</sup> In the court's view, the directors' approval of the recapitalization plan effected an immediate transfer of control to senior management and the ESOP, which the court probably assumed to be predictably allied with the interests of the management stockholders.<sup>150</sup> As the court assumed that, under *Revlon*, the "sale" of a company could readily mean the transfer of voting control of a company,<sup>151</sup> and as American Standard by other indicia was the object of a bidding contest, the appropriate standard against which to assess the decisions of American Standard's directors was the auctioneering principle articulated in *Revlon*. Applying the *Revlon* standard the court evaluated the directors' decisions, made contemporaneously with their approval of the recapitalization plan, to adopt a severance plan for salaried employees assigned to the corporate staff, to be triggered by a change in corporate control, and to amend the corporation's retirement and savings plan so that all accrued benefits would vest immediately upon a change

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146. See *Turner Broadcasting Sys. v. CBS, Inc.*, 627 F. Supp. 901, 906-07 (N.D. Ga. 1985).

147. See 506 A.2d 173, 182-83.

148. Nos. 88-50, 88-104, slip op. at 28 n. 3 (D. Del. Mar. 16, 1988) (1988 U.S. Dist. LEXIS 2680).

149. *Id.* at 32 n. 8.

150. The court's opinion does not address this point separately. See *id.* at 34 (characterizing "entire Recapitalization Plan" as "an offer to gain control of American Standard").

151. See *id.* at 27-28.

in control.<sup>152</sup> But the directors expressly exempted the recapitalization plan from the definition of events constituting a change in control of American Standard. The effect, in the court's view, was to treat the parties competing for control of American Standard in an unjustifiably unfair manner: if Black & Decker acquired control of American Standard, it would bear the \$50 million estimated cost of the severance plan and the immediate loss of \$80 million due to the accelerated pension payments. The court concluded that when the board amended the pension plan and adopted the severance plan, it adopted plans "designed to deter bidding" rather than obtain a higher price for American Standard's shareholders.<sup>153</sup>

The general significance of *Black & Decker* may be limited by the fact that the directors adopted the recapitalization plan only after a third party made a tender offer for the company's shares. Given such a sequence, the directors' ability to argue that the company is not "in play" is obviously more limited than if the recapitalization strategy is not prompted by a hostile bid, even if both plans have a comparable impact on voting control of the company. In any event, the *Anderson, Clayton* transactions illustrate that directors might well regard even these "non-sale" alternatives with considerable skepticism. The court's opinion in *Anderson, Clayton* effectively narrows the circumstances in which the directors could justify coercing shareholders into accepting the recapitalization proposal rather than an alternative proposal not favored by management or the directors. Only if the disfavored alternative is itself coercive or unfair in some way can a coercive response be justified. Thus, even if a recapitalization proposal does not mean that the company goes "up for sale," the directors may still be limited in their ability to ensure the proposal's success.

Even in the absence of a competing bid, Delaware law limits the directors' ability to structure a transaction so that shareholders are coerced into accepting it. In *Kahn v. United States Sugar Corp.*,<sup>154</sup> the vice chancellor held that the highly leveraged nature of the issuer's self-tender for seventy-five percent of its shares obliged it to offer its public shareholders a fair price; the directors coerced shareholders into accepting the offer because the large debt incurred to finance the transaction would greatly diminish the value of the remaining shares.<sup>155</sup> Prior to the self-tender, a majority of the corporation's shares were owned by individual members of one family and charitable organizations affiliated with them. The court's holding, however, does not limit the obligation to offer a fair price in a "coercive" transaction to minority shareholders in corporations controlled by a majority shareholder or group of shareholders. In addition, the concept of coercion potentially encompasses many issuer-sponsored transactions. Is any leveraged transaction "coercive" if remaining

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152. *Id.* at 12-13. Other issues that the court might well have considered—including the directors' adoption of a poison pill rights plan—were not pursued by the plaintiffs in their motion for preliminary injunctive relief. After the litigation was well underway, American Standard's management learned of the imminent appearance of a bid from a new party at a higher price than either the recapitalization plan or Black & Decker's bid. Additionally, the directors agreed to terminate the poison pill if a majority of American Standard's shares were purchased through a formal tender offer. *See id.* at 18.

153. *Id.* at 45.

154. *See* No. 7313 (Del. Ch., Dec. 10, 1985), reported in 11 DEL. J. CORP. L. 908 (1986).

155. *Id.* at 918.

a shareholder after the transaction is less attractive than accepting the issuer's proposal? Further development on this score is likely.

#### V. POLICY ALTERNATIVES

What, if anything, is to be done? Not surprisingly, management buyouts have evoked a range of proposed policy prescriptions from commentators. Prior to evaluating these proposed reforms of corporate law and securities regulation, the relatively small impact such revisions are likely to have on the frequency and magnitude of such transactions should be emphasized. It is not likely, and perhaps not even imaginable, that the basic enabling provisions in corporate law that facilitate these transactions will be abolished. Thus, short of a categorical ban on MBO's—which, as we shall see shortly, presents serious problems of definition—reforms in corporate law and securities regulation can affect the distribution of gains from MBO's and leveraged recapitalizations and can reduce the advantages of management-sponsored bidding groups. Significant changes in the frequency or magnitude of the transactions are likely to stem from other sources. Chief among these is a downward shift in demand for the assets created by these transactions—bank loans and debt and equity securities—which will inevitably drop with the next cyclical dip in the general business cycle.

In evaluating the policy alternatives, it is important to bear in mind that no persuasive rationale has been advanced for a regime of corporate law that permits directors to favor management-sponsored transactions so decisively that no competing proposal can succeed. If the principal interest to be served by the directors is that of the company's shareholders, directors should not be free to ensure that the transaction sponsored by management and its allies will trump all competing bids. Even if the directors may properly take into account interests other than those of shareholders—including concerns of the company's present creditors and its non-managerial employees—the dislocations following an MBO or a leveraged recapitalization can be as significant as those in the wake of a hostile takeover.<sup>156</sup>

A simple preference for the interests of the management participants in the transaction does not commend itself when fundamental changes in the company's structure and ownership are at issue. Likewise, it is difficult to rationalize the potential for substantial gain for management holders of MBO equity as a systematically useful incentive toward excellence in the discharge of managerial responsibilities prior to the MBO's emergence. As the prior discussion illustrates, only some types of companies are prime candidates for MBO's. As conventionally these have been enterprises combining limited prospects for additional growth with stable cash flow, why structure incentive systems to draw the highest-quality managerial talent into the slow lane of corporate activity? Thus, the policy alternatives to be considered

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156. In one reported instance, managers slashed the newco's work force by 30% after the MBO. See Anders, *Many Firms Go Public Within a Few Years after Leveraged Buyout*, WALL ST. J., Jan. 2, 1987, at 1, col. 6 (describing Anchor Glass Containers, Inc.).

are additional limitations on directors' ability to facilitate management-preferred transactions.

Any credible response to the MBO phenomenon must begin by recognizing the essential difference between these transactions and sales of assets to third parties. MBO's, unlike other sales, are not transactions in which one can safely assume, other things being equal, that the persons negotiating on the selling corporation's behalf are pursuing exclusively its interests and those of its shareholders. Advocates of an absolute prohibition on MBO's stress the strategic advantages afforded management proponents—who choose the time for the transaction—coupled with the risk that public stockholders will be undercompensated when their equity interest is eliminated. This risk is enhanced by management's control over the development and presentation of the information against which the transaction's fairness will be assessed by the company's directors and its financial advisors. The perceived unfairness of requiring public shareholders to bear this risk is aggravated by both the practical difficulty of determining whether undercompensation has occurred once a public market for the company's shares no longer exists and by the costliness and awkwardness of using the statutory appraisal proceedings to test the adequacy of the MBO price.<sup>157</sup>

An absolute prohibition on MBO's would not necessarily sacrifice gains to shareholders that result when a management-sponsored group is willing to make a higher bid than other bidders.<sup>158</sup> Management groups could be permitted to bid but not be permitted to structure the transaction so that public equity is entirely eliminated. The effects of the prohibition are limited because the ban would apply only to transactions that take the company private, and not to the varied forms of leveraged recapitalizations that sharply increase management's equity stake and reduce the proportion of public equity without eliminating it entirely. Careful specifications of the minimum acceptable percentage of public equity would be essential to implement a ban on MBO's. Thus, the key policy question is the desirability of forcing proponents of MBO's to use the various leveraged recapitalization structures in their stead.

One reason to prefer rules compelling the use of leveraged recapitalizations stems from post-MBO transactions in which equity in the newco is sold to the public. One such recent offering occurred barely a year after the MBO was completed, on terms giving the equity investors in the MBO stock valued at 2.7 to five times what

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157. See Brudney & Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354, 1367–68 (1978) (advocating prohibition on all going private transactions unless proponents of a transaction can establish that public stock ownership is inconsistent with the company's continued viability).

Moreover, after the market crash many companies that completed public offerings after LBO's are reportedly considering new LBO's. The "re-LBO" is attractive if the company had good earnings in 1987 but did not establish much of an investor following before the crash. Additionally, in most newly-public former LBO's, substantial shareholdings are still held by the original owners and their investment partners, which simplifies the re-LBO process. Few former LBO's offered to the public in 1987 ever rose in price much beyond the initial offering price, and some of these issues were among those most severely depressed in price after the crash. See Smith, *Market's Depressed Prices are Breeding a Variation of the Leveraged Buy-Out*, WALL ST. J., Jan. 25, 1988, at 50, col. 1.

158. But see Lowenstein, *supra* note 71, at 779 (observing that ban on MBO's would deprive shareholders of the higher price that management-allied groups may be willing to pay).

they paid for it.<sup>159</sup> A one-year round trip between MBO and public offering does not suggest a compelling justification for restricting the gains produced to the equity stake-holders in the MBO. The prospect that holders of newco equity can profit handsomely, as in this transaction, principally as a result of fortuitous changes in stock market prices and short term interest rates, and do so quickly, raises the suspicion that the public equity-holders were undercompensated initially, or that they based their approval of the transaction on a faulty assessment of its fairness. Or at least it illustrates the perplexities involved in determining whether a particular MBO proposal offers public shareholders adequate compensation, if market conditions relevant to the assessment of financial adequacy change rapidly. A leveraged recapitalization enables public shareholders to elect whether to retain the stub shares they receive, and thereby to share in any subsequent windfall gains. Of course, most round-trips back to the public equity market do not occur as rapidly after most MBO's, but policy-makers may appropriately shape rules to deal with extreme as well as typical occurrences. This particular "extreme occurrence" is especially troublesome because it followed in the wake of the \$6.2 billion MBO for Beatrice Cos., the single largest MBO to date. Even after the market collapse reduced the likely price at which Beatrice could be resold, the profit on the total transaction would still be massive and the eventual sale might still be the most profitable of its type.<sup>160</sup>

Definitional problems would similarly complicate the implementation of an auctioneering requirement for MBO's, that is, a set of rules barring management and directors from using devices that give an MBO group an advantage over other bidders and that oblige the company to provide the information needed to bid, and the time in which to do so, to responsible non-management bidders. An auctioneering requirement would work best if the company's decision to sell must be irrevocable,<sup>161</sup> and an effective rule would need to specify carefully the type of proposed transaction that would trigger the auctioneering regime. Purely private searches for other bidders, as the preceding discussion of *Anderson, Clayton* illustrates, are not the most effective strategy for implementing an auctioneering requirement. More effective would be a requirement that the fact of the MBO proposal be publicly announced, coupled with a requirement that non-public information equivalent to that given the MBO group be made available to other prospective bidders, who could in turn be required to agree to treat the information received as confidential. Prospective competing bidders would also need sufficient time to finance and present their proposals.

Although the resulting rules would be complex, leveraged recapitalizations could similarly be subjected to an auctioneering requirement triggered by a specified proportional enhancement of management's equity stake. In addition, if the auctioneering requirement only applied to transactions proposed by a management group,

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159. See Smith, *Planned Offer of Beatrice Assets Gives Look at Success of Most Leveraged Buyouts*, WALL ST. J., June 5, 1987, at 51, col. 3.

160. See Burrough & Johnson, *Profit from Sale of Beatrice May be Cut by \$1 Billion Due to Stock-Market Crash*, WALL ST. J., Dec. 7, 1987, at 12, col. 1.

161. See Lowenstein, *supra* note 71, at 779.



defining those groups would be of great practical importance. If the definition of "management group" turns on an allocation of newco shares to members of the company's senior management, allocations instead to management participants of options on shares or of convertible debt are likely to become popular unless the definition of "management group" is broadly drawn. Considerable care would also be needed to define the transactions that impermissibly advantage the "management group's" proposal.

One could, of course, favor the imposition of both of these limitations. The practical result would be to limit management-allied groups to leveraged recapitalizations, while denying them any unbeatable advantage over proponents of control transactions not endorsed by management. Would anything of value be lost as a consequence? One might, of course, fear that if management-allied groups are denied an inside track and denied the opportunity to allocate all of the reorganized company's equity to themselves, they will decline to bid at all, and public shareholders will lose the higher prices their participation in bidding contests may stimulate. The recent popularity of leveraged recapitalization proposals, however, undercuts the factual basis for the fear that, denied the opportunity to be entirely selfish, management groups will not bid at all. Likewise, MBO proposals continued unabated after courts in key jurisdictions imposed the "neutral auctioneering" role on directors. But many of the unappealing aspects of these transactions at present would be reduced, if not entirely eliminated, by rules along these lines.

